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No. 89-

Supreme Court, U.S.

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**In the
Supreme Court of the United States.**

OCTOBER TERM, 1989.

MICHAEL J. CONNOLLY,
MASSACHUSETTS SECRETARY OF STATE,
AND
BARRY C. GUTHARY, DIRECTOR,
MASSACHUSETTS SECURITIES DIVISION,
PETITIONERS,

v.

SECURITIES INDUSTRY ASSOCIATION, ET AL.,
RESPONDENTS.

**Petition for a Writ of Certiorari
to the United States Court of Appeals
for the First Circuit.**

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QUESTION PRESENTED

Does the Federal Arbitration Act, 9 U.S.C. § 1 et seq., preempt a State from protecting investors by (1) requiring securities brokers to disclose the legal effects of mandatory, pre-dispute arbitration agreements, and (2) prohibiting brokers from requiring an arbitration agreement as a non-negotiable condition of opening a brokerage account?

PARTIES TO THE PROCEEDING

The petitioners are identified in the caption. In addition to the respondent listed in the caption, the following are respondents:

Dean Witter Reynolds, Inc.;
Donaldson, Lufkin & Jenrette
Securities Corp.;
Drexel Burnham Lambert, Inc.;
Fidelity Brokerage Services, Inc.;
Kidder Peabody & Co.;
Merrill, Lynch, Pierce,
Fenner & Smith, Inc.;
Paine Webber Inc.;
Prudential-Bache Securities, Inc.;
Shearson Lehman Hutton, Inc.;
Smith Barney, Harris Upham & Co.

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Petitioners,

v.

SECURITIES INDUSTRY ASSOCIATION, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

Michael J. Connolly, Massachusetts Secretary of State, and Barry C. Guthary, Director, Massachusetts Securities Division, respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the First Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1a-52a) is reported at 883 F.2d 1114 (1st Cir. 1989). The opinion of the district court (App. 55a-130a) is reported at 703 F. Supp. 146 (D. Mass. 1988).

JURISDICTION

The judgment of the court of appeals was entered August 31, 1989. App. 53a. The court of appeals held that certain Massachusetts regulations were invalid as repugnant to the Federal Arbitration Act, 9 U.S.C. § 1 et seq. Petitioners invoke the jurisdiction of this Court under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Art. VI, cl. 2, of the United States Constitution provides:

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land[.]

The Massachusetts regulations at issue are Title 950 Code of Massachusetts Regulations (CMR) 12.204(a)(2)(G) 1.a-c. The text of the regulations appears in the addendum to the opinion of the court of appeals, App. 49a-52a, and in the text of the opinion of the district court. App. 62a-63a n.5.

Section 28 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78bb(a)(1982 ed.), provides in pertinent part:

Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.

Section 2 of the Federal Arbitration Act, 9 U.S.C. § 2 (1982 ed.) (the Act), provides in pertinent part:

A written provision in any . . . contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

Section 3 of the Act, 9 U.S.C. § 3 (1982 ed.), provides:

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement[.]

Section 4 of the Act, 9 U.S.C. § 4

(1982 ed.), provides:

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States District Court which, save for such agreement, would have jurisdiction . . . of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement.

* * *

The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement.

* * *

If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof.

STATEMENT OF FACTS

In September, 1988, the Massachusetts Secretary of State issued regulations (1) requiring securities brokers to disclose to customers the legal effects of a mandatory "pre-dispute" arbitration clause in a brokerage agreement, and (2) prohibiting brokers from requiring such an arbitration clause as a non-negotiable condition of opening a brokerage account.

The Secretary promulgated the regulations pursuant to his authority under federal and state securities laws to regulate the conduct of securities brokers. See 15 U.S.C. § 78bb(a) (1982 ed.); Mass. Gen. Laws c. 9, § 1; c. 110A, § 412. Massachusetts has

broadly regulated the sale of securities since 1921. See Mass. St. 1921, c. 499. Massachusetts' regulation of securities brokers - like that of all other state "blue-sky" authorities - protects investors from unfair and dishonest broker conduct. See Mass. Gen. Laws c. 110A, § 101 et seq. (Uniform Securities Act).

The stated purpose of the regulations is to "provide the customer with a meaningful choice prior to making a decision to sign the [arbitration] agreement." Mass. Register No. 593 (October 14, 1988). As the district court found, the prevailing practice in the brokerage industry is not to advise prospective customers of the legal effects of the arbitration clause, and

is to require retail customers to agree to arbitrate disputes as a condition to opening a brokerage account. App.

66a-69a.^{1/}

The Massachusetts regulations address these practices by requiring disclosure and bargaining in the formation of arbitration agreements.

^{1/} A 1987 study by the Securities and Exchange Commission (SEC), credited by the district court, confirms the growing trend by brokers to require arbitration for all securities accounts in the wake of Shearson/American Express v. McMahon, 482 U.S. 220 (1987). The study "found that arbitration agreements were all but universal for margin accounts (89 percent of the firms used such agreements) and for option accounts (83 percent of the firms used such agreements)," that 40 percent of the firms use arbitration agreements in cash accounts, and that 30 percent of the firms surveyed "had under active consideration plans to expand the number of accounts for which an arbitration agreement would be required." App. 69A n. 7.

The regulations do not prohibit brokers from entering into pre-dispute arbitration agreements with customers. A broker may enter an arbitration clause if he discloses its legal effect and does not insist on the clause without offering anything in return.^{2/} A broker may, for example, negotiate a commission discount for customers who agree to arbitrate future disputes, or charge a higher commission to those who do not agree to the clause. See App. 116a. Nor do the regulations deem unenforce-
able those arbitration agreements which are entered into without compliance

^{2/} Under the rules of the self-regulatory organizations, brokers are required to arbitrate upon the request of the customer, even in the absence of a predispute arbitration agreement. See Appendix to Brief of Appellant, First Circuit Docket No. 89-1022 at 469.

with the regulations. Rather, the regulations make the prohibited practices subject to sanction in broker disciplinary proceedings. See Mass. Gen. Laws c. 110A, § 204.

STATEMENT OF PRIOR PROCEEDINGS

On September 22, 1988, the Securities Industry Association and nine brokerage firms (the "industry") filed their complaint in the United States District Court for the District of Massachusetts. App. 56a. On abbreviated cross-motions for summary judgment, the district court declared the regulations preempted by the Act. App. 57a-58a, 99a-106a, 131a-132a. The

court of appeals affirmed. Although conceding that "[t]he Commonwealth may well be correct that [arbitration clauses] ought to be arrived at with greater negotiation and disclosure between broker-dealers and customers than currently takes place," App. 46a, the court ruled that "[e]ven if regulators find industry-wide practices that would be grounds for voiding arbitration agreements at common law, e.g., fraud or coercion, any separate regulatory action [such as the Massachusetts disclosure requirement] or sanction singling out arbitration agreements from contracts generally would be preempted" by the Federal Arbitration Act. App. 24a-25a (emphasis original). As petitioners

demonstrate in Part III, infra, this reasoning seriously misconstrues the purposes and objectives of the Act.

REASONS FOR GRANTING THE WRIT

- I. THE DECISION BELOW PRESENTS AN IMPORTANT QUESTION CONCERNING THE AUTHORITY OF THE STATES TO PROTECT INVESTORS IN THE FORMATION OF ARBITRATION AGREEMENTS.

This case presents a question of national significance for the regulation of securities brokers by the States. Review by this Court is necessary to determine the extent of state authority to protect investors in the formation of arbitration agreements.

The growing use of mandatory arbitration agreements in the securities

and commodities industries in the wake of Shearson v. McMahon, 482 U.S. 220 (1987), has drawn increasing attention from federal and state regulators and legislators. The intense interest of state regulators is shown by the actions of the North American Securities Administrators Association (NASAA). In December, 1987, NASAA urged Congress to require brokers to negotiate arbitration agreements and to provide potential customers with a separate document explaining the terms and implications of mandatory arbitration clauses. See Statement of James C. Myer Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, December 16, 1987. NASAA supported its Congressional testimony

with its "Investor Hotline Study," a report which found that many of the investors who complained to NASAA after the October, 1987, market "crash," did not know that they had signed an arbitration clause and did not understand its implications. See App. 59a-60a n.2.^{3/}

In October, 1988, NASAA adopted a "Resolution Concerning the Execution of Compulsory Pre-Dispute Arbitration

^{3/} NASAA submitted further testimony to Congress in 1988 in support of the proposed "Securities Arbitration Reform Act of 1988," H.R. 4960, 100th Cong., 2d Sess. (June 30, 1988), which would have required disclosure and prohibited brokers from making pre-dispute arbitration clauses a condition of doing business. See 134 Cong. Rec. E 2233 (remarks of Cong. Boucher); E 2239-41 (remarks of Cong. Dingell); E 2245-46 (remarks of Cong. Markey) (daily ed. June 30, 1988) 2 Cong. Index (CCH) at 35,106 (100th Cong.); App. 61a n. 4.

Agreements as a Condition Precedent to Obtaining Brokerage Services," in which NASAA expressed "support [for] the goals and policies of the Massachusetts rules as being consistent with NASAA's purpose of advancing the principle of investor protection and affording choice to investors in their decisions to participate in the securities markets." App. 59a-60a n.2. NASAA also filed a brief amicus curiae in the court of appeals in this case which stated that "at least 15 other members [of NASAA] would consider adopting some form of regulation covering mandatory arbitration clauses and disclosure of investor rights." Brief at 4.^{4/}

^{4/} NASAA also is expected to file a brief amicus curiae in this Court supporting this petition.

The national importance of this issue is similarly shown by the actions of federal agencies which have addressed mandatory arbitration clauses. The Commodities Futures Trading Commission (CFTC), for example, has enforced regulations similar to the Massachusetts regulations since 1976. Title 17 C.F.R. 180.3(b) precludes a commodities broker from entering into a mandatory predispute arbitration agreement with a customer unless, inter alia, the agreement is not a condition for the customer to utilize the services of the broker, and the agreement contains cautionary language in large bold-face type, separately endorsed by the customer, that enumerates the customer's rights and the legal effect of the agreement. The

existence of § 180.3(b) prompted the CFTC to file a letter in the court of appeals in this case which stated that "Commission regulation 180.3 does not conflict with the Federal Arbitration Act because both provisions reflect a policy favoring the arbitration of commodities disputes, and because regulation 180.3 enhances, not diminishes, the likelihood that pre-dispute arbitration agreements that comply with its terms will be enforced."^{5/}

^{5/} In promulgating its original regulations in 1976, the CFTC considered arguments that the cautionary language "would be in the nature of a warning against use of an arbitration procedure and would thus discourage persons from signing pre-dispute arbitration agreements[,]" and that "[s]uch warnings are not usual in commercial contracts,' and 'can only result in frightening away some customers.'" 41 Fed. Reg. 42,943

(footnote continued)

The Securities and Exchange

Commission (SEC) has also recently (but partially) addressed voluntariness in the entry of arbitration agreements. On May 10, 1989, the SEC issued an "Order Approving Proposed Rules Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc., Relating to the Arbitration Process and the Use of Predispute Arbitration

(footnote continued)

(Sept. 29, 1976). In response, the CFTC reiterated "its positive attitude toward the settlement of disputes by arbitration. It does not follow from this, however, that the Commission can or should leave a customer unaware of the purpose of the agreement he is requested to sign." Id. The CFTC noted that it believed that "cautionary language is necessary to assure an informed consent on the part of the customer at the time he enters into the arbitration agreement." Id.; see 41 Fed. Reg. at 42,945.

clauses." 54 Fed Reg. 21,144 (May 16, 1989). See App. 32a-33a. As the court of appeals noted below, the SEC approved exchange rules "requiring brokers to discuss customers' rights under mandatory arbitration agreements and to include language in arbitration clauses informing customers that they are waiving judicial fora." Id. at 32a-33a. The SEC declined, however, to adopt rules that would prohibit brokers from requiring arbitration clauses as a condition of opening an account, on the hope that "competitive forces" in the market would provide more choice. 54 Fed. Reg. at 21,154.^{6/}

^{6/} That brokerage firms uniformly require arbitration agreements and do not offer arbitration-less accounts even at higher prices suggests a classic market failure. Investors do not shop

(footnote continued)

The court of appeals dismissed the CFTC and SEC actions as irrelevant because they are "products of federal, not state, authority." App. 33a. But the actions of these federal regulators strongly support certiorari in this case because they demonstrate that there is national interest in the issues

(footnote continued)

for brokerage firms on the basis of arbitration clauses because they do not focus on the eventuality of a dispute arising with their broker. See Rakoff, Contracts of Adhesion: An Essay in Reconstruction, 96 Harv. L. Rev. 1174, 1226-1227 (1983). And brokerage firms do not compete on arbitration clauses precisely because they do not want customers to focus on such an eventuality, for fear of souring their customer relationships. See, e.g., Affidavit of Theodore Kresbach, ¶ 6, 1st. Cir. App. 688-89. In this way, agreements without arbitration clauses are similar to consumer product safety features or warranties which are offered at inefficient levels in the absence of regulation. See, e.g., Posner, Strict Liability: A Comment, 2 J. Leg. Stud. 205, 211 (1973).

presented and important public interests protected by the Massachusetts regulations. Further, the belated and limited SEC action shows that there is a pressing need for a decision by this Court defining the extent of state authority to supplement federal regulation of the disclosure and negotiability of arbitration agreements.

In sum, the Massachusetts regulations address a new problem in an established area of state concern - the conduct of securities brokers. In taking limited steps to assure voluntariness in arbitration agreements, Massachusetts has served as a "laboratory" for the development of new protections for investors. See New State Ice Co. v. Liebmann, 285 U.S. 262,

311 (1932) (Brandeis, J., dissenting).

The court of appeals struck down these protections as repugnant to the Federal Arbitration Act. Plenary review is necessary in order to rectify the error below and define the extent of state power in this important area.

II. THE DECISION HAS NATIONAL IMPLICATIONS FOR STATE REGULATION OF MANDATORY ARBITRATION AGREEMENTS IN BANKING, HEALTH CARE, AUTOMOBILE, AND MANY OTHER INDUSTRIES.

Review by this Court is also necessary in order to define the scope of state power to regulate, in any fashion, the formation of arbitration

clauses in consumer agreements in banking, health care, car sales, and other areas of historic state concern. Under the preemption theory applied by the court of appeals, a state is powerless to require disclosure in connection with arbitration clauses in consumer contracts unless the State requires the same disclosure in all contracts, whether or not involving consumers. Prompt and plenary review by this Court will define the authority of the States to apply traditional consumer protection regulation to arbitration agreements and avoid harm to consumers and the States that will flow from inconsistent decisions in the lower courts.

Mandatory arbitration clauses in the banking industry are becoming commonplace. See J. Butler, Arbitration in Banking - State of the Art (Robert Morris Associates, 1988); California Banks are Using Arbitration to Cut Court Costs, Avoid Jury Verdicts, 2 ADR Rep. (BNA) 181-82 (May 12, 1988). Bank of America, for example, currently includes mandatory arbitration clauses in commercial loans and consumer safety deposit agreements. J. Butler, supra, at 24. Similarly, Marathon National Bank, a commercial bank based in Los Angeles, "has decided to initiate arbitration for virtually all its disputes with customers, vendors, employees, and others." Id. at 26-27.

The use of mandatory arbitration clauses has also spread to agreements between patients and their doctors and health insurers. Under common agreements between doctors and patients, patients agree to mandatory arbitration of future claims of medical malpractice. See generally Note, Medical Malpractice Arbitration: A Patient's Perspective, 61 Wash. Univ. L. Rev. 123 and App. A and C (1983); see also Sanchez v. Sirmons, 121 Misc.2d 249, 467 N.Y.S.2d 757 (1983) (arbitration clause in "consent to abortion" form).

Health insurers have similarly included mandatory arbitration clauses in group health benefit contracts. See, e.g., Madden v. Kaiser Foundation

Hospitals, 17 Cal.3d 699, 131 Cal. Rptr. 882, 552 P.2d 1178 (1976) (contract between Kaiser Foundation Health Plan, Inc., and the State of California, governing group medical plan for state employees). Mandatory arbitration clauses thus cover thousands of private and state and federal employees. See id., 552 P.2d at 1180; Dinong v. Superior Court, 102 Cal. App.3d 845, 162 Cal. Rptr. 606 (1980) (contract between Kaiser Foundation Health Plan, Inc., and the United States Civil Service Commission); see also 5 U.S.C. § 8902 (1988 ed.) (Office of Personnel Management authorized to contract for group health benefit plans for federal employees).

While many States endorse the arbitration of medical service claims, many of the same States require disclosure and bargaining of agreements to arbitrate such claims. For example, California specifies the precise language that must be used in arbitration clauses in all "contracts for medical services," and requires notice, in "10 point bold red type," that the arbitration agreement waives the "right to a jury or court trial." Cal. Civ. Proc. Code § 1295(a) and (b) (West 1982 ed.). Other States require similar disclosures. See Ohio Rev. Code Ann. § 2711.23 (Banks-Baldwin 1989 Supp.) (requiring, inter alia, a separate document for the arbitration agreement); South Dakota Cod. Laws Tit. 21-25B-3

(Michie 1987 ed.) Michigan requires that the agreement "shall be accompanied by an information brochure. . . ."
Mich. Comp. Laws § 600.5041 (West 1987 ed.)

In addition to requiring disclosure of the waiver of a patient's right to a trial, Illinois requires language, in specified form and size, informing persons that they "cannot be required to sign [the arbitration] agreement in order to receive treatment." Ill. Rev. Stat. c. 10, § 209 (West 1987 ed.).
Alaska and Michigan have similar requirements. See Alaska Stat. § 0.9.55.535(b) (Michie 1988 ed.) (requiring "in bold print on face of agreement" statement that "execution of the agreement is not a prerequisite to

receiving treatment or care; form used "shall be approved in advance by the attorney general of the state to assure that it fairly informs both parties to the agreement and properly protects their interests"); Mich. Comp. Laws § 600.5041(2) and (5) (West 1987 ed.); see also South Dakota Atty. Gen. Op. No. 76-98 (health maintenance organization's enrollee contracts cannot make arbitration agreement a prerequisite to medical care or treatment).

Yet another industry affected by the issue presented in this case is the automobile industry. In Saturn Distribution Corp. v. Williams, Commissioner of the Department of Motor Vehicles of Virginia, 717 F. Supp. 1147 (E.D. Va. 1989), the district court held that

the Federal Arbitration Act does not preempt a Virginia statute which prohibits automobile manufacturers from requiring franchise dealers to sign arbitration clauses as a condition of dealership agreements. The district court expressly rejected the reasoning of the courts below in this case. The Fourth Circuit will hear oral argument on the manufacturers' appeal in Saturn on December 6, 1989. (Docket No. 89-2773). Whatever the outcome of that appeal, the Saturn case shows that the implications of the decision below in this case extend far beyond the securities industry.

The issue presented by these state statutes governing disclosure and bargaining is not whether arbitration

agreements in consumer contracts may be enforced, (see Southland Corp. v. Keating, 465 U.S. (1984)), but whether the States have any authority to ensure that arbitration agreements are entered into knowingly and voluntarily, in lieu of case by case adjudications under traditional contract law doctrines. This issue is squarely presented by this petition and warrants plenary review at this time.

III. THE DECISION BELOW
MISCONSTRUED THE PURPOSES
AND OBJECTIVES OF THE FAA.

The "FAA contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy

the entire field of arbitration." Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University, 109 S.Ct. 1248, 1254 (1989). Whether a state law is preempted by the FAA thus depends on whether it "stands as an obstacle to the accomplishment and execution of the full proposes and objectives of Congress." Id. at 1255 (quoting Hines v. Davidowitz, 312 U.S. 52, 67 (1941)). The decision below purported to apply this preemption test, but the court misconstrued the purposes and objectives of the FAA.^{7/}

^{7/} The court below also appears to have placed on Massachusetts the burden of proving that Congress did not intend to preempt the state regulations. See App. 19a (noting duty of courts to "defend [the Act's] mechanisms vigilantly and with some fervor," and to "be on guard

(footnote continued)

"Congress' principal purpose" in enacting the FAA, which the court below ignored, was to "ensur[e] that private arbitration agreements are enforced according to their terms." Volt, 109 S.Ct. at 1255. Thus, this Court has held that state "anti-waiver" laws, which "require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by

(footnote continued)

for artifices in which the ancient suspicion of arbitration might reappear"); App. 31a (noting that the state had failed to carry its burden "to show that Congress intended to preclude a waiver of judicial remedies"). This was error since "federal law pre-empts state law in traditional fields of state regulation only when 'that was the clear and manifest purpose of Congress.'" E.g., Coit Independence Joint Venture v. Federal Savings and Loan Ins. Corp., 109 S.Ct. 1361, 1377 (1989) (Scalia, J., concurring) (quoting Rice v. Sante Fe Elevator Corp., 331 U.S. 218, 230 (1947)).

arbitration," are preempted by the Act. Southland Corp. v. Keating, 465 U.S. 1, 10 (1984) (state law that made agreements to arbitrate certain franchise claims unenforceable held preempted because it "directly conflicts" with section 2 of the Act); Perry v. Thomas, 482 U.S. 483, 491 (1987) (similar state law barring enforcement of agreement to arbitrate wage-collection claims held preempted because it was in "unmistakeable conflict" with federal policy). However, this Court has never suggested that state laws, such as the Massachusetts regulations, that simply require disclosure and bargaining in the formation of arbitration agreements in a regulated industry are preempted.

Such disclosure and bargaining requirements do not conflict with the Act's primary purpose of "enforcing arbitration agreements according to their terms," because they do not limit the ability of parties to enter into arbitration agreements, nor limit the enforcement of arbitration agreements once entered. On the contrary, by serving as a prophylactic against "claims that the agreement to arbitrate resulted from ... fraud or overwhelming economic power," Mitsubishi Motors v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 627 (1985), such state laws advance the primary purpose of the Act by making it more likely that arbitration agreements that conform to the laws will be enforced. See Brief Amicus Curiae of

the CFTC in the First Circuit

("Commission regulation 180.3 does not conflict with the FAA because both provisions reflect a policy favoring the arbitration of commodities disputes, and because regulation 180.3 enhances, not diminishes, the likelihood that pre-dispute arbitration agreements that comply with its terms will be enforced."); see also Smokey Greenhaw Cotton v. Merrill Lynch Pierce Fenner & Smith, Inc., 720 F.2d 1446, 1450 (5th Cir. 1983) (broker's compliance with CFTC Rule 180.3 militates against claim of fraud).

The court below nonetheless held the Massachusetts regulations preempted because it found that the regulations conflicted with the Act's "liberal federal policy favoring arbitration

agreements." App. 18a-39a (quoting Moses H. Cone Memorial Hospital v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983)). The court viewed the regulations as a "gyve" or "shackle" that would "inhibit a party's willingness to create an arbitration agreement" or would "frustrate" arbitration. App. 27a. But this view is contrary to the views of both the CFTC and the SEC. See Amendments to CFTC Rules Governing Arbitration or Other Dispute Settlement Procedures, 41 Fed. Reg. 42,943 (Sept. 29, 1976) (CFTC has "positive attitude toward the settlement of disputes by arbitration. It does not follow from this, however, that the Commission can or should leave a customer unaware of

the purpose of the agreement he is requested to sign."); Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., et al., 54 Fed. Reg. 21,144, 21,154 (May 16, 1989) (hereinafter cited as SEC Order) (disclosures alerting investors to the meaning of arbitration contracts they are signing "should promote more knowledgeable acquiescence or rejection by customers of arbitration provisions"). Moreover, the record is devoid of any basis on which the court below could reasonably predict the likely effect of the regulations on arbitration agreements, since the regulations permit brokers to induce investors to enter

into arbitration agreements, e.g., by offering a reduced commission.^{8/}

In any event, the court below misconstrued the "liberal federal policy favoring arbitration" to suggest that arbitration per se is a goal of the FAA. E.g., App. 3a ("The hope has long been that the Act could serve as a therapy for the ailment of the crowded docket.") This approach conflicts with the recent ruling of this Court that "[w]hile Congress was no doubt aware

^{8/} In opposing summary judgment in the district court, Massachusetts moved for relief under Fed. R. Civ. P. 56(f). App. 99a-106a, 48a n.10. As grounds for its motion Massachusetts cited its pending discovery, which sought additional facts concerning the alleged effects of the regulations on the entry of arbitration agreements by brokers and customers. The district court denied the motion, and the court of appeals essentially affirmed. App. 106a, 48a n.10.

that the Act would encourage the expeditious resolution of disputes, its passage 'was motivated, first and foremost, by a congressional desire to enforce agreements into which parties had entered.'" Volt, 109 S.Ct. at 1254 (quoting Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 220 (1985)). Thus, in Volt this Court upheld the application of a state arbitration rule, which had been incorporated into an arbitration agreement via a choice-of-law provision, "even if the result is that arbitration is stayed where the Act would otherwise permit it to go forward." Volt, 109 S.Ct. at 1255. Moreover, this Court has "recognized that the FAA does not require parties to arbitrate when they have not agreed

to do so." Id. At bottom, therefore, the liberal federal policy favoring arbitration is not, as the court below suggested, a policy designed to promote a particular kind of conduct, but rather a policy to "give effect to the contractual rights and expectations of the parties. . . ." Volt, 109 S.Ct. at 1256; see H.R. Rep. 96, 68th Cong., 1st Sess. 1 (1924) ("effect of the bill is simply to make the contracting party live up to his agreement").

To the extent the Act was designed, in part, to promote arbitration, it was plainly intended to facilitate consensual arbitration. See Volt, 109 S.Ct. at 1256 ("Arbitration under the Act is a matter of consent, not

coercion"); S. Rep. No. 536, 68th Cong., 1st Sess. 1, 3 (1924) ("The record ... shows not only the great value of voluntary arbitrations but the practical justice in the enforced arbitration of disputes where written agreements for that purpose have been voluntarily and solemnly entered into.") (emphasis added); see also Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 414 (1967) (legislative history demonstrates that Act was not intended to cover arbitration clauses offered to captive customers or employees or a take-it-or-leave-it bases) (Black, J. dissenting) (citing Hearing on S. 4213 and S. 4214 before the Subcommittee of the Senate Committee on the Judiciary, 67th Cong., 4th Sess. 9-11 (1923));

Shearson/American Express Co. v.

McMahon, 482 U.S. 220, 226, 230 (1987)

(voluntariness of agreement irrelevant to whether Exchange Act of 1934 bars waiver of judicial remedies but well-founded claim of fraud or excessive economic power would provide basis for voiding agreement under ordinary principles of contract law).

The Massachusetts regulations were designed to "provide the customer with a meaningful choice prior to making a decision to sign the agreement," Mass. Reg. No. 593 (October 14, 1988), in market circumstances in which the customer's choice has been sharply restricted.^{9/} Thus, the Massachusetts

^{9/} See SEC Order, 54 Fed. Reg. at 21,153 n. 51 (SEC study found that nearly all brokerage firms required

(footnote continued)

regulations are faithful to the federal policy favoring consensual arbitration.

The court below also found the regulations preempted because they "take their meaning precisely from the fact that a contract to arbitrate is at issue," App. 40a (quoting Perry v. Thomas, 482 U.S. at 492 n.9), and thus allegedly conflict with the Act's "principle of rigorous equality." App. 20a. The court rejected as "casuistry"

(footnote continued)

retail customers to sign a pre-dispute arbitration agreement to open a margin or option account; 39% of firms required such agreements for cash accounts); see also Ames v. Merrill Lynch, Pierce, Fenner & Smith, 567 F.2d 1174, 1178 (2d Cir. 1977) ("It ... became apparent [to the CFTC] that in many cases arbitration was not undertaken voluntarily by customers, but that customers were compelled to agree to predispute arbitration clauses as a precondition to doing business.")

the Commonwealth's argument below that, because the regulations apply conditions to the formation of securities arbitration agreements that are common to, if not the rule of, Massachusetts consumer contracts generally and securities transactions in particular, the regulations were consistent with the Act's "equal footing" objective. See Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. at 219 (Act was designed in part "to place [arbitration] agreements 'upon the same footing as other contracts,'" (quoting H.R. Rep. No. 96, 68th Cong., 1st Sess. 1, 2 (1924))).^{10/} The court held: "Even if regulators find industry-wide practices that would be grounds to

^{10/} This was the view of the district court in Saturn Distribution Corp. v. Williams, 717 F. Supp. at 1152-1153.

voiding arbitration agreements at common law, e.g., fraud or coercion, any separate regulatory action or sanction singling out arbitration agreements from contracts generally would be preempted." App. 24a-25a (emphasis in original). Thus, according to the court below, a state securities regulator may only require disclosure or bargaining in the formation of arbitration agreements in the securities industry if the state requires such disclosure or bargaining in the formation of all contracts and contract terms, and if the state does so by means of a regulatory sanction.

This application of the Act's "equal footing" objective is irrational and does violence to the objectives of the

FAA. Massachusetts does not require disclosure and bargaining in all contracts, because market circumstances do not universally demand such regulation, particularly as between commercial enterprises. However, given the circumstances in which securities brokers generally employ arbitration agreements (i.e., in a highly regulated industry, with disparity in bargaining power between brokers and retail investors, the absence of competition among brokers on arbitration terms, investors' lack of meaningful choice, and investors' right under the exchange rules to demand arbitration even in the absence of an arbitration agreement), exempting securities arbitration agreements from minimal consumer

protection regulation -- "Congress barred the states from making determinations about arbitration contracts that states remained free to make about, say, used car sales," App. 24a -- places arbitration agreements on a footing well above other contracts, contrary to the intent of Congress. See Prima Paint v. Flood & Conklin Manufacturing Co., 388 U.S. 395, 404 n.12 (1967) (Act was designed "to make arbitration agreements as enforceable as other contracts, but not more so"). Plenary review is necessary to rectify the court's misreading of congressional intent and to prevent further harm to legitimate state regulation.

CONCLUSION

For the reasons set forth above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 89-1022

SECURITIES INDUSTRY ASSOCIATION, et al.,

Plaintiffs, Appellees,

v.

MICHAEL J. CONNOLLY, ETC., et al.,

Defendants, Appellants.

APPEAL FROM THE UNITED STATES
DISTRICT COURT FOR THE
DISTRICT OF MASSACHUSETTS

[Hon. Douglas P. Woodlock,
U.S. District Judge]

Before

Campbell, Chief Judge,
Selya, Circuit Judge,
and Caffrey,* Senior District Judge.

August 31, 1989

*of the district of Massachusetts,
sitting by designation.



SELYA, Circuit Judge. Hypertrophy is the pathologic "overgrowth . . . of an organ or part . . . resulting from unusually steady or severe use" Webster's Third New International Dictionary 1114 (1981). Metaphorists seem to find the condition irresistible. Thus, hypertrophy has been used as a partial explanation for the collapse of entire intellectual systems, e.g., Kuhn, The Structure of Scientific Revolutions (2d ed. 1970), and detailed mechanical intellectual artifacts, e.g., Posner, Goodbye to the Bluebook, 54 U. Chi. L. Rev. 1343 (1986). We succumb today to the same temptation, for we find the metaphor especially apt in discussing the rampant growth of the civil docket in the United States.

We need not belabor the point.

Increased resort to the courts, and the consequent tumefaction of already-swollen court calendars, have received considerable attention, see, e.g., Heydebrand & Seron, The Rising Demand for Court Services, 11 Just. Sys. J. 303 (1986); Galanter, The Day After the Litigation Explosion, 46 Md. L. Rev. 3 (1986); Lieberman, The Litigation Society (1981), so we merely note the phenomenon and do not comment further upon it. We focus instead on arbitration, a contractual device that relieves some of the organic pressure by operating as a shunt, allowing parties to resolve disputes outside of the legal system. Congress passed the Federal Arbitration Act (FAA or Act), 9 U.S.C. §§ 1-14 (1982), to help legitimate

arbitration and make it more readily useful to disputants. The hope has long been that the Act could serve as a therapy for the ailment of the crowded docket. As might be expected, there is a rub: the patient, and others in interest, often resist the treatment.

I

We are asked to decide today if certain regulations, Mass. Regs. Code tit. 950, §§ 12.204 (G)(1)(a)-(c) (Regulations), set forth in the appendix hereto, are preempted by the FAA. The Regulations are part of a set which governs the conduct of those who sell securities in the Commonwealth. The provisions at issue were promulgated at one time. Neither party suggested to

the district court that any of the provisions might be severable, so we treat them as a unit for purposes of our preemption analysis. See Clauson v. Smith, 823 F.2d 660, 666 (1st Cir. 1987) (court of appeals will ordinarily eschew consideration of theories not raised below).

The contracts to which the Regulations apply implicate interstate and international commerce, as well as the instrumentalities of that commerce, thus subjecting them to the reach of the FAA. See 9 U.S.C. § 1; see generally Societe Generale de Surveillance, S.A. v. Ratheon European Management and Systems Co., 643 F.2d 863, 867 (1st Cir. 1981) (the term "commerce" as used in the Act is to be broadly construed). Specifically, the Regulations are aimed

at broker-dealers who require customers to sign pre-dispute arbitration agreements (PDAAs) as a concomitant of establishing account relationships. Not coincidentally, many of the major brokerage firms prefer to follow some such praxis. Cf. Drayer v. Krasner, 572 F.2d 348, 353-54 (2d Cir.), cert. denied, 436 U.S. 948 (1948) (discussing industry-wide use of arbitration to resolve disputes between broker-dealers and registered representatives).

The Regulations not only regulate; they do so in a manner patently inhospitable to arbitration. They (i) bar firms from requiring individuals to enter PDAAs as a nonnegotiable condition precedent to account relationships, § 12.204(G)(1)(a); (ii) order the prohibition brought "conspicuously" to the attention of prospective customers,

§ 12.204(G)(1)(b); and (iii) demand full written disclosure of "the legal effect of the pre-dispute arbitration contract or clause," § 12.204(G)(1)(c).

In Massachusetts, regulation of securities falls within the province of the Secretary of State, who superintends the Securities Division. Immediately upon adoption of the Regulations in September 1988, the Securities Industry Association and ten brokerage firms affiliated with it^{1/} sued in federal

^{1/} The ten houses comprise Dean Witter Reynolds, Inc., Donaldson, Lufkin & Jenrette Securities Corp., Drexel Burnham Lambert, Inc., Fidelity Brokerage Services, Inc., Kidder Peabody & Co., Merrill Lynch, Pierce, Fenner & Smith, Inc., PaineWebber Inc., Prudential-Bache Securities Inc., Shearson Lehman Hutton, Inc., and Smith Barney, Harris Upham & Co. We refer to them and the trade association plaintiff, collectively, as "SIA" or "appellees."

district court seeking a declaration that the Regulations were unconstitutional because they conflicted with the provisions and policies of the FAA. SIA also sought a preliminary injunction barring enforcement of the Regulations. The suit named the Secretary of State and the director of the Securities Division (appellants before us) as defendants. Claiming that the Commonwealth had power to issue the Regulations as part of its concurrent authority to regulate securities transactions, see Mass. Gen. L. ch. 110A, §§ 201, 204 (1984) (governing registration of broker-dealers), appellants stood their ground. Cross-motions for summary judgment were

eventually filed. In due course, in district court granted declaratory and injunctive relief in appellees' favor. Securities Indus. Ass'n v. Connolly, 703 F. Supp. 146 (D. Mass. 1988). This appeal followed.

III.

A

The Supremacy Clause of Article VI of the federal Constitution prevents the states from impinging overmuch on federal law and policy. See Louisiana Pub. Serv. Comm'n v. FCC, 476 U.S. 355, 368 (1986). Preemption - the vehicle by which the Supremacy Clause is generally enforced - always boils down to a matter

of congressional intent. Schneidewind v. ANR Pipeline Co., 108 S.Ct. 1145, 1150 (1988); California Fed. Sav. & Loan Ass'n v. Guerra, 479 U.S. 272, 280 (1987); Wardair Canada, Inc. v. Florida Dep't of Revenue, 477 U.S. 1, 6 (1986); French v. Pan Am Express, Inc. 869 F.2d 1, 2 (1st Cir. 1989); Wood v. General Motors Corp., 865 F.2d 395, 401 (1st Cir. 1988). And, because Congress has not expressly delineated the preemptive reach of the FAA, our task is to determine the extent of any implied preemption vis-a-vis the state's Regulations.

We have acknowledged before that "[t]he concept of implied preemption has a certain protean quality," a circumstance which tends to defeat courts' efforts to establish tidy

creedal subcategories. French, 869 F.2d at 2. Yet, although we continue to "abjure taxonomy for taxonomy's sake," id., it is sometimes helpful to sketch the borders of the doctrine by reference to commonly used descriptions. Thus, it has been said that implied preemption prospers when Congress intends its enactments "to occupy a given field to the exclusion of state law."

Schneidewind, 108 S.Ct. at 1150. That is not the case here: Congress did not want the FAA to occupy the entire field of arbitration law. Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ., 109 S.Ct. 1248, 1254 (1989); New England Energy Inc. v. Keystone Shipping Co., 855 F.2d 1, 4 (1st Cir. 1988), cert. denied, 109 S. Ct. 1527 (1989). State law may also

be preempted "when it actually conflicts with federal law." Schneidewind, 108 S. Ct. at 1150; see also Perry v. Thomas, 482 U.S. 483, 491 (1987). In this respect, substance takes precedence over form; a direct, facial contradiction between state and federal law is not necessary to catalyze an "actual conflict" within the doctrinal parameters of the Supremacy Clause.

Whatever labels may be affixed, the pivot upon which our inquiry turns remains constant: where Congress has failed explicitly to detail the dimensions of displacement, courts must decide if "the state law disturbs too much the congressionally declared scheme" Palmer v. Liggett Group, Inc., 825 F.2d 620, 626 (1st Cir. 1987); see also French, 869 F.2d at 2 (adopting a practical preemption

analysis which focuses "on the effect which the challenged enactment will have on the federal plan"). Put another way, a state law or regulation cannot take root if it looms as an obstacle to achievement of the full purposes and ends which Congress has itself set out to accomplish. Schneidewind, 108 S.Ct. at 1151; California Coastal Comm'n v. Granite Rock Co., 107 S.Ct. 1419, 1425 (1987); Silkwood v. Kerr-McGee Corp., 464 U.S. 238, 248 (1984); Hines v. Davidowitz, 312 U.S. 52, 67 (1941).

B

Here, then, the critical inquiry is whether the FAA is an enactment which Congress meant to remain relatively unfettered; and if so, whether the Regulations intrude impermissibly. We

approach our task mindful both that interpretation of a statute's meaning must start with the text itself, United States v. James, 478 U.S. 597, 604 (1986), and that the language chosen by Congress must be accorded its ordinary meaning, American Tobacco Co. v. Patterson, 456 U.S. 63, 68 (1982). In this instance, the relevant statutory phraseology is not technical, embodies conventional terms, and has a virtue of brevity:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. § 2. The language sweeps broadly and brooks little reservation. We must, therefore, be chary of a narrowing construction, lest such an interpretive modality clog the channel Congress has opened. See Volt, 109 S. Ct. at 1254-55.

Reluctance to shrink the scope of section 2 seems particularly well advised given the Supreme Court's resounding endorsement of the "ordinary language" technique in construing the FAA. See, e.g., Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 404 (1967). The Court has concluded that this approach comports with Congress's "unmistakably clear . . . purpose that the arbitration procedure, when selected by the parties to a contract, be speedy and not subject to

delay and obstruction." Id. Nor is Prima Paint in any sense aberrational; just this year, in the course of overruling Wilko v. Swan, 346 U.S. 427 (1953) (a decision voiding certain PDAAAs under § 14 of the Securities Act of 1933), the Court again emphasized "the strong language" of the FAA and noted the heavy burden borne by opponents of the arbitral alternative. See Rodriguez de Quijas v. Shearson/American Express, Inc., 109 S.Ct. 1917, 1921 (1989).

C

Because the language of the Act seems clear, and its meaning plain, we are not obliged to plumb the Congress's collective consciousness to ascertain legislative intent. James, 478 U.S. at

606; Rubin v. United States, 449 U.S. 424, 430 (1981). It nevertheless seems prudent to do so, if only "[a]s a check upon our reading of the statute."

Kwatcher v. Massachusetts Service Employees Pension Fund, No. 88-1930, slip op. at 9 (1st Cir. July 5, 1989).

In recent decades, the Supreme Court has faced a number of disputes involving the FAA. In case after case, the Justices have read the Act's legislative history with an avuncular eye; as the court below perspicaciously observed, "[r]ecent history has found the Supreme Court offering endorsements of the arbitration process by expansive statements of the intent of Congress in passing the Federal Arbitration Act." 703 F. Supp. at 150-51 (citing representative cases). We have lately witnessed yet another illustration of

this trend. See Rodriguez de Quijas, 109 S.Ct. at 1920 (acknowledging the Court's "current strong endorsement of the federal statutes favoring [arbitration]"). Although an arbitral remedy has not invariably prevailed, see, e.g., Alexander v. Gardner-Denver Co., 415 U.S. 36, 51-52 (1974) (Title VII employment discrimination claim could be litigated in a judicial forum notwithstanding PDAA), the Court has almost always given the Act a reading which is both broad and deep.

Congress, we are told, enacted the FAA to relieve parties from what, even two-thirds of a century ago, was characterized as "'the costliness and delays of litigation.'" Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213, 220 (1985) (quoting H.R. Rep. No. 96, 68th Cong., 1st Sess. 2 (1924)). Common-law

courts had jealously guarded the sovereign's perceived prerogative to handle disputes among its constituents, preserving the courts' jurisdiction to resolve controversies once they had been solemnized. Byrd, 479 U.S. at 220 n.6. The FAA was enacted to overcome this "anachronism." Id. In harmony with that purpose, the Act declares "a liberal federal policy favoring arbitration agreements." Moses H. Cone Memorial Hospital v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983); see also Rodriguez de Quijas, 109 S.Ct. at 1919; Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 625 (1985). Such a policy is desirable because it best effectuates the "congressional desire to enforce agreements into which parties had entered." Byrd, 470 U.S. at 220. At

the same time, courts must be on guard for artifices in which the ancient suspicion of arbitration might reappear. See Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 226 (1987); Byrd, 470 U.S. at 221.^{2/}

In sum, the legislative history of the FAA, like its text, indicates that the courts must receive the Act hospitably and defend its mechanisms vigilantly and with some fervor.

D

The metaphors used to describe the Court's interpretations are somewhat

^{2/} We think that the Court, by taking the formidable step of overruling its own precedent, has demonstrated how tightly impulses hostile to arbitration must be constrained in order to remain faithful to Congress's mandate. See Rodriguez de Quijas, 109 S.Ct. at 1920 (in part, Wilko must fall because it is "pervaded by . . . 'the old judicial hostility to arbitration'" (citation omitted)).

varied, but their common denominator is a principle of rigorous equality under 9 U.S.C. § 2.^{3/} Given this interpretive

3/ Volt is not to the contrary. There, the Court ruled that "interpreting a choice-of-law clause to make applicable state rules governing the conduct of arbitration - rules which are manifestly designed to encourage resort to the arbitral process - simply does not offend the rule of liberal construction . . . nor does it offend any other policy embodied in the FAA." 109 S. Ct. at 1254 n.5. But, the choice-of-law provision in Volt did not impinge on the validity or enforceability of the arbitral contract. See id. at 1254. The California regulation filled in an interstice in the FAA, id at 1254 n. 5, whereas the Regulations here at issue plainly undermine the presumption of validity that the Act meant to confer on arbitration contracts generally. See Perry, 482 U.S. at 492 n.9 (making distinctions between choosing which law of unconscionability applies and not

(footnote continued)

model, and the statute's twofold use of the term "any" - it is, after all, "difficult to imagine broader language," James, 478 U.S. at 604 (footnote omitted) - the words of 9 U.S.C. § 2 must be ceded their full import. What seems beyond dispute at this juncture is that no state may simply subject arbitration to individuated regulation in the same manner as it might subject some other unprotected contractual device (say, a prescriptive period or exculpatory clause contained within a private contract). Thus, for example, the Eighth Circuit struck down Missouri's effort to require that

(footnote continued)

whether law of unconscionability applies to arbitration); see also New England Energy, 855 F.2d at 4-5 (states may enact regulations to fill gaps left by the FAA).

contracts highlight the existence of arbitration clauses by use of 10-point capital letters, Webb v. R. Rowland & Co., 800 F.2d 803, 806 (8th Cir. 1986), and earlier refused to honor a state requirement that arbitration agreements bear an attorney's acknowledgement attesting that all parties had been informed of the agreement's effects, Collins Radio Co. v. Ex-Cell-O-Corp., 467 F.2d 995, 997 (8th Cir. 1972). Any similar liminary approach would seemingly defeat the very aim of the Act, allowing states to revivify the ancient jurisdictional antagonism toward arbitration by cloaking it in regulatory garb. At the very least, such enmity, however manifested in state law,^{4/} is

^{4/} That the restriction is administrative rather than legislative or judge-made in no way validates appellants' maneuver.

(footnote continued)

preempted. Volt, 109 S. Ct. at 1253;
Perry, 482 U.S. at 492 n.9; Mitsubishi
Motors, 473 U.S. at 626-27; Byrd, 470
U.S. at 219-21; Southland Corp. v.
Keating, 465 U.S. 1, 18-19 (1984); Moses
Cone, 460 U.S. at 24-25; Prima Paint,
388 U.S. at 404 n.12; New England
Energy, 855 F.2d at 4-5.

Appellants conceded before the
district court, 703 F. Supp. at 152, and
on appeal, that the Regulations apply
only to arbitration agreements. They

(footnote continued)

The gravamen of the FAA is to preserve
the arbitral bargain against external
onslaughts manifesting hostility to
arbitration, whatever their genesis.
The only excepted areas are those where
Congress (expressly, by fair
implication, or by delegation) has
itself exhibited a preference for some
other forum or rule. See McMahon, 482
U.S. at 226-27; Kroog v. Mait, 712 F.2d
1148, 1154 n.5 (7th Cir. 1983), cert.
denied, 465 U.S. 1007 (1984).

suggest, however, that this bespeaks no unfriendliness: the Commonwealth treats arbitration agreements like other contracts between businesses and consumers, that it, it regulates them as extensively as necessary for the public weal. In our view, that self-congratulatory casuistry will not wash. Indeed, we think it evident that it was precisely this sort of categorization error which Congress sought to cure when it enacted the FAA.

In creating a body of substantive law convering arbitration, Congress barred the states from making determinations about arbitration contracts that the states remained free to make about, say, used car sales. Perry, 482 U.S. at 492 n.9; McMahon, 482 U.S. at 226. Even if regulators find industry-wide practices that would be

grounds for voiding arbitration agreements at common law, e.g., fraud or coercion, any separate regulatory action or sanction singling out arbitration agreements from contracts generally would be preempted. PDAA's may be void on these grounds, exactly as would contracts of other types conceived fraudulently or in unduly coercive circumstances - no more, no less. The FAA prohibits a state from taking more stringent action addressed specifically, and limited, to arbitration contracts.

That is not to say that a state can do nothing about a perceived problem. The Commonwealth's powers remain great, so long as used evenhandedly. The FAA does not prohibit judicial relief from arbitration contracts which are shown to result from fraud or enormous (unfair)

economic imbalance of the sort sufficient to avoid contracts of all types.^{5/} Rodriguez de Quijas, 109 S. Ct. at 1921. "Thus state law, whether of legislative or judicial origin, is applicable [and not preempted] if that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally." Perry, 482 U.S. 492 n.9 (emphasis in original). Massachusetts could also pass legislation declaring all contracts

^{5/} Although any fraudulent, adhesive, or economically coerced agreement to arbitrate would be challengeable, the Supreme Court has suggested that such challenges must not only be brought on grounds common to contracts generally, but must also be proven on the facts of the individual case, not automatically shunted to one side according to practices governing the formation of arbitration agreements as a class of contracts. See Rodriguez de Quijas, 109 S.Ct. at 1921.

of adhesion presumptively unenforceable. See Rakoff, Contracts of Adhesion: An Essay in Reconstruction, 96 Harv. L. Rev. 1173, 1248 n. 239 (1983). Such a rule would apply to arbitration contracts, among others. But Massachusetts may not say (judicially, legislatively, or in a regulatory mode) that "adhesion contracts are especially bad when arbitration is included, so we will therefore ban, or place gyves and shackles upon, only those adhesive contracts which contain arbitration clauses." That kind of value judgment is foreclosed precisely because the FAA ordains that the state's appulse toward arbitration agreements must be the same as its approach to contracts generally. Perry, 482 U.S. at 492 n.9; McMahon, 482 U.S. at 226.

Appellants also urge us to find that, notwithstanding the general rule, Congress carved out an exception to the Act by permitting states concurrently to regulate securities transactions. We need not linger long over this asseveration. The Court has recently addressed the theoretical overlap between securities regulation and the FAA, holding that claims under section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2), could be the subjects of arbitration. Rodriguez de Quijas, 109 S. Ct. at 1922. The same holds true for claims arising under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). McMahon, 482 U.S. at 227-28, 238. There, the Court noted

that "[w]hen Congress enacted the Exchange Act in 1934, it did not specifically address the question of the arbitrability of § 10(b) claims." Id. at 227. Congress's failure explicitly to resolve the potential conflict between the FAA and the 1933 and 1934 Acts has impelled the Court to determine the proper boundaries. In so doing, the Justices set forth an analytic framework which we find important to our inquiry.

Starting with the premise that the FAA was intended to have the full breadth apparent from its plain language, the Court noted that the 1934 Act "provides no basis for disfavoring agreements to arbitrate statutory claims by skewing the otherwise hospitable inquiry into arbitrability." McMahon, 482 U.S. at 226 (quoting Mitsubishi

Motors, 473 U.S. at 627); see also
Rodriguez de Quijas, 109 S.Ct. at
1920-21. If claims actually based on a
federal statute are not sacrosanct, then
we can see no reason why ordinary
—contractual relations between customers
and broker-dealers would not be
accessible to the reach of the FAA.
Such dealings strike us as well within
the universe of possible topics
"otherwise hospitable" to arbitration.
As such, they are subject to the full
force of the FAA's core command: that
an arbitration contract be treated like
"any contract." 9 U.S.C. § 2.

Simply put, nothing in the
Securities Act, the Exchange Act, or the
grant of concurrent power to the states
to regulate securities manifests a
congressional intent to limit or

prohibit waiver of a judicial forum for a particular claim, or to abridge the sweep of the FAA. Rodriguez de Quijas, 109 S.Ct. at 1920; McMahon, 482 U.S. at 226. And we are mindful that: "The burden is on the party opposing arbitration . . . to show that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue." McMahon, 482 U.S. at 226; see also Mitsubishi Motors, 473 U.S. at 628 (parties should be held to arbitral bargain "unless Congress itself has evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue"); Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc., 806 F.2d 291, 295 (1st Cir. 1986) (court must "enforce the [arbitral] agreement unless . . . the Congressional

intent in enacting the [right-creating]
statute was to preclude the waiver of
judicial remedies") (emphasis in
original). That burden has not been
carried.

Nor are we willing to infer implicit
congressional approval of the
Commonwealth's policy simply because the
Commodities Futures Trading Commission
(CFTC) has adopted rules, see 17 C.F.R.
§ 180.3 (1988), not dissimilar in spirit
from the Massachusetts regulations. The
same holds true of recent Securities and
Exchange Commission (SEC) activities,
including the SEC's approval of rules
submitted by three self-regulatory
organizations requiring brokers to
discuss customer's rights under
mandatory arbitration agreements and to
include language in arbitration clauses

informing customers that they are waiving judicial fora. See Order Approving Proposed Rule Changes, 54 Fed. Reg. 21,144 (1989). Both CFTC's rulemaking and the SEC's acquiescence are products of federal, not state, authority. That is a critical distinction. See McMahon, 482 U.S. at 226 (the "Act's mandate may be overridden by a contrary congressional command") (emphasis supplied); Felkner v. Dean Witter Reynolds, Inc., 800 F.2d 1466, 1468 n.3 (9th Cir. 1986). Congress has not structured a similar arbitration exception for securities in general and certainly not for state regulation of securities in particular. Kroog v. Mait, 712 F.2d 1148, 1154 n.5 (7th Cir. 1983), cert. denied, 465 U.S. 1007 (1984).

We go one extra step. If Congress meant to exempt the regulation of securities from the FAA's sphere of influence, "such an intent 'will be deducible from [the statute's] text or legislative history,' or from an inherent conflict between arbitration and the statute's underlying purpose." McMahon, 482 U.S. at 227 (citations omitted); accord Rodriguez de Quijas, 109 S.Ct. at 1920. There is nothing in the language of the Securities Act, the Exchange Act, or the pertinent legislative history, which points in such a direction. By the same token, appellants have utterly failed to demonstrate any inherent conflict or to suggest any valid reason why "arbitration is inadequate to protect the substantive rights at issue."

McMahon, 482 U.S. at 229. The opposite seems true: any remnants of Wilko's "outmoded presumption of disfavoring arbitration proceedings" have been laid to rest, once and for all. Rodriguez de Quijas, 109 S.Ct. at 1920.^{6/}

The long and short of it is that we can find no evidence of a clear congressional command to override the unambiguous pro-arbitration mandate of the FAA in the securities field.

^{6/} McMahon adequately evinces the point. There, only a dissenter, not the Court's majority, felt that arbitration could fail to protect an investor's substantive rights. 482 U.S. at 257-66 (Blackmun, J., dissenting).

III

A

Ordinarily, our determination that the Regulations conflict with the requirement that arbitration contracts be treated on a par with contracts generally would end the matter. Here, however, there is a further wrinkle. On their face, the Regulations do not govern PDAAAs at all. Rather, they purport to address broker-dealers who would require customers to sign PDAAAs. This difference, appellants tell us, is determinative.

The dialectic is too clever by half. Even if we grant the claim that a contract made in the face of such an ethical order to a contracting party would be enforceable - a claim open to

considerable doubt, and upon which we express no opinion^{7/} - the Regulations would still be preempted. Without recognizing it, appellants appear to have trapped themselves in a trick box.

7/ It is hornbook law that one who violates a licensing statute - which, as here, is not a revenue measure, but a public-protection statute - is generally not allowed to enforce the contract. The usual case arises where an unlicensed party performs services requiring a license. See, e.g., Shinberg v. Bruk, 875 F.2d 973, 976 (1st Cir. 1989) (attorney not licensed as real estate broker barred from claiming finder's fee). In this situation, however, the terms of the contract constitute the basis for the ethical proscription. Thus, the closer analogy would seem to be that if, "in making and performing [the contract] he defrauded the other party, the latter has a good defense" 6A A. Corbin, Corbin on Contracts, § 1510 (1962); see also J. Calamari & J. Perillo, Contracts § 22-7 (2d ed. 1977); Restatement (Second) of Contracts § 181 (1981). Moreover, as the district court pointed out, 703 F. Supp. at 149, Mass. Gen. L. ch. 110A, § 410(f) would likely prevent a broker from enforcing a contract made in violation of the Regulations.

As the district court noted and documented, unconscionability is the standard for voluntariness in Massachusetts. 703 F. Supp. at 152-53. Either the Regulations create a stricter standard for PDAA's, or they are functionally meaningless. If the former, then the Regulations, by requiring what is not generally required to enter contracts in the Commonwealth, e.g., certain negotiations, explanations, and disclosures, inhibit a party's willingness to create an arbitration contract or undermine the contract's enforceability (if the party proceeds notwithstanding the edict). By itself, such an ethical mandate is sufficient to lead us to rule that the Regulations go too far.

State law need not clash head on with a federal enactment in order to be preempted. If state law "stands as an obstacle to the accomplishment of the full purpose and objectives of Congress," it must topple.

Schneidewind, 108 S. Ct. at 1151

(citations omitted); see also French,

869 F.2d at 7 (state statute preempted

when "too discommoding" to federal

scheme); Palmer, 825 F.2d at 629 (state

tort liability preempted when

enforcement would be "seriously

disruptive to the congressionally

calibrated balance of national

interests"). In enacting the FAA,

Congress evinced an unmistakable

"federal policy favoring arbitration

agreements," one which was to be applied

liberally. Moses Cone, 460 U.S. at 24.

Court are to do so even where "state substantive or procedural policies" run to the contrary, always resolving "any doubts concerning the scope of arbitrable issues . . . in favor of arbitration." *Id.* at 24-25. Wherever there is "an allegation of waiver, delay, or a like defense to arbitrability," we must heed the underlying federal interest. *Id.* at 25. The lesson is entirely clear: "A state law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue does not comport with [the equality] requirement of § 2." *Perry*, 482 U.S. at 492 n.9.^{8/} That is to say, courts

^{8/} Technically, as appellants are quick to note, the statements of the *Perry* Court contained in footnote 9 of its opinion are dicta. But, we find them to be considered dicta, reflective of the applicable rule of law.

must follow congressional intent and "foreclose state legislative attempts to undercut the enforceability of arbitration agreements." Southland, 465 U.S. at 16. The legal standard is whether the Regulations take their meaning from the fact that a contract to arbitrate is at issue, or frustrate arbitration, or provide a defense to it. If so, the federal policy requires that we resolve all doubts in favor of arbitration, finding the Regulations preempted.

In this instance, we conclude as a matter of law that the Regulations actually conflict with the FAA and the federal policy embedded therein. The Regulations leave no room for speculation: it is unarguable from their wording that they derive their

essential meaning from the fact that a contract to arbitrate is at issue. As the district court noted, the Commonwealth's wistful assertion that the Regulations are not addressed to the validity and enforceability of PDAAs "can be maintained only by assuming that no provision of state law other than one directly governing contract validity or enforceability comes within the preemptive reach of the Arbitration Act." 703 F. Supp. at 156. That assumption is so seriously flawed that it cannot be countenanced.

The Regulations must also fall because they are at odds with the policy which infuses the FAA. The power to suspend a license is much more than a shift in costs; it is the economic equivalent of the death penalty. The

worry that requiring a PDAA might
forfeit a firm's ability to function as
a broker-dealer at all is an obstacle of
greater proportions even than the chance
that, in a given dispute, an arbitration
agreement might be declared void. To
the extent that the substantive state
policy to foster "ethical"
broker-dealers, embodied in the
Regulations here at issue, conflicts
with the federal policy to "favor[]
arbitration agreements," Moses Cone, 460
U.S. at 24, it is preempted.

B

A policy designed to prevent one
party from enforcing an arbitration
contract or provision by visiting a
penalty on that party is, without much

question, contrary to the policies of the FAA. But, there is at least one other way in which the Massachusetts policy would erode the goals of the Act. The Regulations are aimed at nonnegotiable "standard-form" PDAAAs. Arbitration is a positive good in the eyes of the courts and Congress not just because it relieves crowded calendars, but because it relieves an often unnecessary elaboration of social practices. As the Court has stated, resort to arbitration "trades the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration." Mitsubishi Motors, 473 U.S. at 628. We must, therefore, be vigilant lest we recreate even the beginnings of hypertrophy in the

formation of arbitration contracts. The Regulations demand exactly the kind of inefficiency which arbitration and standard-form contracts (generally legitimate under Massachusetts law) are designed to minify.^{9/} By depriving broker-dealers of the opportunity to employ form contracts, even were there no penalty attached to their use, Massachusetts has acted to undercut the policies of simplicity and expedition that characterize the arbitral alternative.

^{9/} The Court has not seen fit to question use of standard-form contracts in circumstances where parties having apparently unequal bargaining power have agreed to arbitrate. See, e.g., Rodriguez de Quijas, 109 S. Ct. at 1921; Southland, 465 U.S. at 4; see also Webb, 800 F.2d at 807 ("The use of a standard form contract between two parties of admittedly unequal bargaining power does not invalidate an otherwise valid contractual provision.").

IV

The Commonwealth may well be correct that PDAA's ought to be arrived at with greater negotiation and disclosure between broker-dealers and customers than currently takes place. That judgment, however, is not the Commonwealth's to make, at least in its current embodiment, for it singles out arbitration in an impermissible way. The states are forbidden from critical scrutiny expressed in a fashion which might mask historic hostility toward arbitration. Congress sought to avoid having that possibility come to fruition, choosing instead to emphasize and endorse arbitral efficiencies. That value judgment was within the congressional domain - and only

Congress, not the states, may create exceptions to it.

That is not to say, of course, that a state must permit broker-dealers to sail as close to the wind as their consciences (or lack thereof) might permit. Massachusetts has a plenitude of lawful weapons in its ethical armamentarium to preserve the integrity of the securities business as conducted in the Commonwealth and to protect consumers. Cf., e.g., Volt, 109 S. Ct. at 1254. But because the Regulations treat standard-form PDAAs in the securities industry more severely than standard-form contracts are generally treated under Massachusetts law, and because the policies underlying the Regulations, and their method of enforcement, conflict with the national

policy favoring arbitration, the state scheme is too discommoding to the federal plan. The Regulations are, therefore, preempted.

We need go no further.^{10/} The judgment of the district court must be Affirmed.

^{10/} We do not address appellants' contention that the district court erred in denying their motion to defer brevis disposition pending further discovery. See Fed. R. Civ. P. 56(f). According to a supporting affidavit, appellants sought the delay to "assess the impact of the regulations on broker and customer behavior." The motion was not directed at discovery of any facts material to the legal question - whether the FAA preempts the Regulations - which we, like the lower court, have found determinative. Thus, the Rule 56(f) motion is, for our purposes, beside the point. See Paterson-Leitch Co. v. Massachusetts Municipal Wholesale Elec. Co., 840 F.2d 985, 988 (1st Cir. 1988) (to be effective, Rule 56(f) motion must show that facts likely exist which, if obtained, will "engender an issue both genuine and material").

APPENDIX

[to Decision of Court of Appeals]

12.204: Denial, Revocation, Suspension,
Cancellation, and Withdrawal of
Registration

[[a](1) through (a)(2)(F): Reserved]

[G] Dishonest or unethical
practices in the securities business.

1. Broker-dealers. Each broker-dealer shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of its business. Act[s] and practices, including but not limited to the following, are considered contrary to such standards and constitute dishonest or unethical practices which are grounds for denial, suspension or revocation of registration or such other action authorized by law:

- a. Requiring on or after January 1, 1989, that a customer located in Massachusetts, other than a customer that is an institutional investor or financial institution specified in 950 CMR 14.401(e), execute either a mandatory pre-dispute arbitration contract or a customer agreement containing a mandatory pre-dispute arbitration clause that is a non-negotiable precondition to effecting transactions in securities for the account of the customer or opening a securities cash account or margin account by the customer with such broker-dealer;

b. Requesting on or after January 1, 1989, that a customer located in Massachusetts execute either a mandatory pre-dispute arbitration contract or a customer account agreement containing a pre-dispute arbitration clause where the contract or agreement fails to conspicuously disclose that the execution of the contract or agreement cannot be made a non-negotiable precondition to the opening by the customer of a securities account with the broker-dealer;

c. Requesting on or after January 1, 1989, that a customer located in Massachusetts execute either a mandatory pre-dispute arbitration

contract or a customer account agreement containing a pre-dispute arbitration clause without fully disclosing to the customer in writing the legal effect of the pre-dispute arbitration contract or clause;

- d. Being found by a court of competent jurisdiction to have violated M.G.L. c. 93A in connection with the sale of securities; and
- e. Being temporarily or permanently enjoined by any court of competent jurisdiction from violating M.G.L. c. 93A in connection with the sale of securities.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 89-1022

SECURITIES INDUSTRY ASSOCIATION, et al.,
Plaintiffs, Appellees,

v.

MICHAEL J. CONNOLLY, ETC., et al.,
Defendants, Appellants.

JUDGMENT

ENTERED: AUGUST 31, 1989

This cause came on to be heard on
appeal from the United States District
Court for the District of Massachusetts,
and was argued by counsel.

Upon consideration whereof, it is now here ordered, adjudged and decreed as follows: The judgment of the district court is affirmed.

By the Court,

/s/_____

Clerk

APPENDIX C

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

SECURITIES INDUSTRY ASSOCIATION,
DEAN WITTER REYNOLDS, INC.,
DONALDSON, LUFKIN & JENRETTE
SECURITIES CORPORATION,
DREXEL BURNHAM LAMBERT, INCORPORATED,
FIDELITY BROKERAGE SERVICES INC.,
KIDDER PEABODY & CO., INCORPORATED,
MERRILL LYNCH, PIERCE, FENNER &
SMITH, INC.,
PAINEWEBBER INCORPORATED,
PRUDENTIAL-BACHE SECURITIES INC.,
SHEARSON LEHMAN HUTTON INC., and
SMITH BARNEY, HARRIS UPHAM & CO.,
INCORPORATED,

Plaintiffs,

v.

MICHAEL J. CONNOLLY, Secretary of
State, and
BARRY C. GUTHARY, Director,
Massachusetts Securities Division,

Defendants.

MEMORANDUM AND ORDER FOR JUDGMENT

December 19, 1988

WOODLOCK, D.J.

The Commonwealth of Massachusetts, acting under its Blue Sky law authority over brokers and dealers in securities, has issued prospective regulations seeking to control the circumstances under which a broker may require a non-institutional customer located in Massachusetts to agree to arbitration of disputes between them.

The plaintiffs -- the trade association for securities dealers and ten brokerage firms registered to do business as securities broker-dealers in Massachusetts -- challenge these regulations on federal constitutional grounds, contending they are preempted by the Federal Arbitration Act, 9 U.S.C. § 1 et seq. The Act requires that in matters affecting the validity, revocability, and enforceability of

arbitration agreements, those agreements must be treated no differently than other contracts.

Without adopting any view on the advisability of such provisions, I find that the Massachusetts Blue Sky authorities are without power to enforce them. The Massachusetts securities arbitration regulations are not merely state law supplementation concerning matters collateral to the validity and enforceability of arbitration agreements. Rather, they go to the heart of the process of forming contracts to arbitrate. In doing so, they single out arbitration agreements for more demanding standards than are imposed by the general law of contracts in Massachusetts. Consequently, I will grant the plaintiffs' motion for summary judgment and declare the Massachusetts

securities arbitration regulations
preempted by the Federal Arbitration Act.

I

In the wake of Shearson/American Express, Inc. v. McMahon, 107 S.Ct. 2332 (1987), in which the Supreme Court upheld the use of predispute arbitration clauses to govern resolution of controversies between brokers and their customers,^{1/} officials of the Commonwealth of Massachusetts moved quickly to crest the tide of proposals

^{1/} Strictly speaking, McMahon addressed arbitration of statutory securities law claims only under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and did not expressly overrule Wilko v. Swan, 346 U.S. 427 (1953), which had held that a predispute agreement could not be enforced to compel arbitration under § 12(2) of the Securities Act of 1933, 15 U.S.C.

(footnote continued)

to control the circumstances in which such arbitration could be used. While the North American Securities Administrators Association was calling for reform,^{2/} while the United States

(footnote continued)

§ 771(2). The expansive preemptive scope accorded the Federal Arbitration Act in McMahon, however, has placed the continued vitality of Wilko in doubt. A split has appeared in the circuits on the question. Compare Rodriguez De Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296 (5th Cir.) (McMahon effectively overruled Wilko), cert. granted, 57 U.S.L.W. 3347 (U.S. Nov. 15, 1988) (No. 88-385) with Chang v. Lin, 824 F.2d 219 (2d Cir. 1987) (Wilko remains good law in absence of express overruling by the Supreme Court). Presumably the Supreme Court's grant of the petition for certiorari in Rodriguez will resolve this question.

^{2/} NASAA, in a Briefing Paper entitled "Oversight of Securities Arbitration" (June 1988), reported that it had "unveiled in early June a detailed proposal for reform of securities arbitration." Id. at 6. NASAA also announced that it "is exploring the

(footnote continued)

Securities and Exchange Commission was seeking further study and encouraging rule making by the broker/dealer self-regulatory organizations,^{3/}

(footnote continued)

possibility of developing model language for state laws or rules to govern mandatory arbitration clauses in written customer agreements." Id. In October 1988, after this litigation was commenced, NASAA adopted a "Resolution Concerning the Execution of Compulsory Pre-Dispute Arbitration Agreements as a Condition Precedent to Obtaining Brokerage Services," in which it expressed "support [for] the goals and policies of the Massachusetts rules as being consistent with NASAA's purpose of advancing the principle of investor protection and affording choice to investors in their decisions to participate in the securities markets." Second Affidavit of Barry C. Guthary, Exhibit A.

^{3/} In letters dated July 8, 1988, SEC Chairman David S. Ruder requested that all the self-regulatory organizations in the brokerage industry "review the issues raised by the current use of mandatory predispute arbitration agreements" and "report back to the commission by October 15, 1988."

(footnote continued)

while the United States Congress was failing to enact proposed legislation regarding securities dispute arbitration,^{4/} the defendant Secretary of State of the Commonwealth of

(footnote continued)

Statement of David S. Ruder Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce Concerning the Securities Arbitration Process and the Voluntariness of Agreements to Arbitrate Broker-Dealer/Investor Disputes, July 12, 1988 [hereinafter Ruder Statement], Attachment 3. The proposals of the self-regulatory organizations have apparently been received and are under consideration by the Commission. See Wurczinger, SEC Faces Mandatory Arbitration Issue, Nat'l L.J., Nov. 14, 1988, at 21, col. 1.

4/ Legislation introduced by Congressmen Boucher, Dingell, and Markey, H.R. 4960, 100th Cong., 2d Sess. (June 30, 1988), see generally 134 Cong. Rec. E 2233 (remarks of Cong. Boucher); E 2239-41 (remarks of Cong. Dingell); E 2245-46 (remarks of Cong. Markey) (daily ed. June 30, 1988), died in Committee during the last Congress. 2 Congressional Index (CCH) at 35,106 (100th Cong.).

Massachusetts, through the defendant Director of the Massachusetts Securities Division, was taking definitive action.

The defendants' action came on September 21, 1988, in the form of a singular Massachusetts regulatory definition of "dishonest or unethical practices in the securities business" by broker-dealers. See Mass. Regs. Code tit. 950, § 12.204-(a)(2)(G)1.a.-c. 5/

5/ The new definition provides as follows:

(G) Dishonest or Unethical practices in the securities business.

1. Broker-dealers. Each broker-dealer shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of its business. Act[s] and practices, including but not limited to the following, are considered contrary to such standards and constitute dishonest or unethical practices which are grounds for denial, suspension or revocation of registration or such other action authorized by law:

(footnote continued)

(footnote continued)

a. Requiring on or after January 1, 1989, that a customer located in Massachusetts, other than a customer that is an institutional investor or financial institution specified in 950 CMR 14.401(e), execute either a mandatory pre-dispute arbitration contract or a customer agreement containing a mandatory pre-dispute arbitration clause that is a non-negotiable precondition to effecting transactions in securities for the account of the customer or opening a securities cash account or margin account by the customer with such broker-dealer;

b. Requesting on or after January 1, 1989, that a customer located in Massachusetts execute either a mandatory pre-dispute arbitration contract or a customer account agreement containing a pre-dispute arbitration clause where the contract or agreement fails to conspicuously disclose that the execution of the contract or agreement cannot be made a non-negotiable precondition to the opening by the customer of a securities account with the broker-dealer;

c. Requesting on or after January 1, 1989, that a customer located in Massachusetts execute either a mandatory pre-dispute arbitration contract or a

This regulatory definition forbids broker-dealers licensed in Massachusetts from requiring Massachusetts customers to sign a mandatory pre-dispute arbitration agreement as a non-negotiable condition to opening a brokerage account. The definition also requires broker-dealers to disclose fully the legal effects of arbitration agreements before entering into a negotiated contract with a customer. What constitutes negotiability, and what full disclosure of legal effects would consist of, are left undefined by the definition.

(footnote continued)

customer account agreement containing a predispute arbitration clause without fully disclosing to the customer in writing the legal effect of the pre-dispute arbitration contract or clause;

. . . .

Under the Massachusetts securities arbitration regulations, non-negotiability of, and lack of full disclosure of legal effects regarding, arbitration agreements do not become dishonest or unethical until January 1, 1989.

Proscriptions against such "dishonest or unethical practices" by broker-dealers are enforced by the power of the defendant Secretary of State to deny, suspend, or revoke the registration of a broker or brokerage firm. Mass. Gen. L. ch. 110A, § 204. Because an unregistered broker may not transact business in Massachusetts, id. § 201, any broker who wishes to do business in Massachusetts must observe the securities arbitration contract regulations which the definition establishes.

Moreover, if a broker--or for that matter a customer--were to attempt to enforce a contract formed without compliance with the Massachusetts securities arbitration regulations, that attempt would be unavailing. Under Chapter 110A, § 410(f),

[n]o person who has made or engaged in the performance of any contract in violation of any provision of this chapter or any rule or order hereunder, or who has acquired any purported right under any such contract with knowledge of the facts by reason of which its making or performance was in violation, may base any suit on the contract.

If implemented in January, these proscriptions will have an immediate effect on the contracts used by broker-dealers transacting business with customers located in Massachusetts. The affidavits submitted by the plaintiff brokerage firms indicate some variety in

their use of arbitration agreements, but certain elements are common.^{6/}

Mandatory written pre-dispute arbitration agreements in some form are used by all the plaintiffs. And these pre-dispute agreements do not purport to advise customers of the "legal effects" of the arbitration clauses.

^{6/} The written brokerage contracts in which these agreements are contained plainly concern transactions involving interstate and international commerce. For the most part, the purchase and sale of securities is conducted over national exchanges or through traders who are located in New York. The instrumentalities of interstate commerce -- telephones and the mails -- are used to execute and report brokerage trades. Thus, the agreements at issue here fall within the broad construction, see Societe Generale de Surveillance, S.A. v. Raytheon European Management and Systems Co., 643 F.2d 863, 867 (1st Cir. 1981), given the reach of the Federal Arbitration Act, which applies to any "written [arbitration] provision in . . . a contract evidencing a transaction involving commerce." 9 U.S.C. § 2.

Each of the plaintiff brokerage firms use arbitration agreements in its standard margin and option account contracts, with the exception of Shearson Lehman Hutton Inc., which has no arbitration clause in its option account contract. A bare majority of the plaintiffs, however, do not use arbitration accounts in standard cash accounts for individuals, although one member of that majority, Donaldson Lufkin & Jenrette Securities Corporation, does have an arbitration agreement for corporate customers. In addition, Smith Barney, Harris Upham & Co., which has an arbitration agreement in its standard cash account, avers that execution of that arbitration agreement

is not a requirement for opening a Smith Barney cash account.^{1/}

The plaintiffs are unanimous in asserting a desire to require certain customers to agree to arbitrate disputes as a condition to opening an account.

^{1/} The plaintiffs' present practice appears to be fairly representative of the brokerage business generally. The Division of Market Regulation of the United States Securities and Exchange Commission in a 1987 study of the 65 firms which account for 90 percent of the brokerage customer trading accounts, see Ruder Statement, supra note 3, at 8, found that arbitration agreements were all but universal for margin accounts (89 percent of the firms used such agreements) and for option accounts (83 percent of the firms used such agreements). With respect to straight cash accounts, however, the percentage of total accounts using arbitration agreements is only about 40 percent. However, 30 percent of the firms surveyed in the SEC study reported that they had under active consideration plans to expand the number of accounts for which an arbitration agreement would be required. See SEC, Summary of Staff Findings with Respect to the Use of Predispute Arbitration Clauses, Ruder Statement, Attachment 4.

The Massachusetts securities arbitration regulations would change this practice by establishing additional disclosure requirements in an as yet undefined format. The Massachusetts securities arbitration regulations would also prevent broker-dealers from implementing the apparently universal practice of requiring at least certain customers to enter into arbitration agreements for their disputes.

II

In confronting a preemption claim, the "sole task" of the court is to determine the intent of Congress. Massachusetts Medical Soc'y v. Dukakis, 815 F.2d 790, 791 (1st Cir.), cert.

denied, 108 S.Ct. 229 (1987) (quoting California Fed. Sav. & Loan Ass'n v. Guerra, 479 U.S. 272, 280 (1987)). The Federal Arbitration Act preempts the Massachusetts broker arbitration regulations "if and only if Congress intended it to do so." Id.

The question to be addressed is "whether Congress (expressly) did or (impliedly) meant to displace state law or state law concepts in enacting . . . the federal scheme set up by Congress." Palmer v. Liggett Group, Inc., 825 F.2d 620, 625-26 (1st. Cir. 1987). In answering that question, the principal consideration is whether state regulation creates a material disturbance in the field of federal concern. "If the state law disturbs too much the congressionally declared

scheme-whether denominated as 'occupying the field' or 'actually conflicting with federal law' -- it will be displaced through the force of preemption." Id. at 626.

The question whether the Massachusetts broker arbitration regulations at issue here materially disturb the federal arbitration scheme may be answered by reference to the history and the logic of the Arbitration Act.

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At its enactment in 1925, the Act was intended to "revers[e] centuries of judicial hostility to arbitration agreements." Scherk v. Alberto-Culver Co., 417 U.S. 506, 510 (1974).

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In 1953, the courts still harbored reservations about full applicability of the Arbitration Act. The decision that year in Wilko v. Swan, see supra note 1, "reflect[ed] a general suspicion of the desirability of arbitration and the competence of arbitral tribunals." Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987).

In the years after Wilko, however, the Supreme Court systematically rejected the reasons supporting Wilko's suspicion of the arbitration process. By 1987, the Supreme Court could observe that "the mistrust of arbitration that formed the basis for the Wilko opinion in 1953 is difficult to square with the assessment of arbitration that has prevailed since that time." Shearson, 482 U.S. at 233.

Recent history has found the Supreme Court offering forceful endorsements of the arbitration process by expansive statements of the intent of Congress in passing the Federal Arbitration Act. In the last five years, the Court has variously found in the statute an embodiment of "Congress' intent to provide for the enforcement of arbitration agreements within the full reach of the Commerce Clause," Perry v. Thomas, 482 U.S. 483, 490 (1987); an "emphatic federal policy in favor of arbitral dispute resolution," Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 631 (1985); "a national policy favoring arbitration," Southland Corp. v. Keating, 465 U.S. 1, 10 (1984); and "a liberal federal policy favoring arbitration agreements,

notwithstanding any state substantive or procedural policies to the contrary," Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983).

That policy has been set loose with hydraulic pressure, sweeping away any state law purporting to "override the parties' choice to arbitrate rather than litigate in court." New England Energy Inc. v. Keystone Shipping Co., 855 F.2d 1, 4 (1st Cir. 1988). Of course, "the Federal Arbitration Act has never been construed to preempt all state law on arbitration." Id. Nevertheless, as the First Circuit recently observed in New England Energy, "the Supreme Court's decisions support a conclusion that all state laws seeking to limit the use of the arbitral process are superseded by

federal law." Id. (emphasis in original).

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As a matter of logic, analysis of whether state regulations affecting the arbitration choice are preempted focuses on whether the state regulations "single out arbitration agreements" for special treatment. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 723 F.2d 155, 158 (1st Cir. 1983), aff'd in part, rev'd in part, 473 U.S. 614 (1985). The anti-singularity premise has been articulated with both pedestrian and intestinal metaphors. Because the fundamental purpose of the Federal Arbitration Act "was to place an arbitration agreement 'upon the same footing as other contracts, where it

belongs'," Dean Witter Reynolds, Inc.
v. Byrd, 470 U.S. 213, 219 (1985)
(quoting H.R. Rep. No. 96, 68th Cong.,
1st Sess. 1 (1924)), the courts have
been vigilant to ensure that state law
concepts specially directed at
arbitration contracts are not permitted
to "eviscerate" that purpose, even
indirectly. Southland Corp. v. Keating,
465 U.S. at 16 n.11; see, e.g., N&D
Fashions, Inc. v. DHJ Indus., 548 F.2d
722, 727-28 (8th Cir. 1976); Medical
Dev. Corp. v. Industrial Molding Corp.,
479 F.2d 345, 348 (10th Cir. 1973);
Michael v. NAP Consumer Elec. Corp., 574
F. Supp. 68, 70 (D.P.R. 1983)
(Torruella, J.).

The formation of arbitration
contracts can be wholly a matter of
state law "if that law arose to govern

issues concerning the validity, revocability, and enforceability of contracts generally." Perry v. Thomas, 107 S.Ct. at 2527 n.9 (emphasis in original.) However, "[a] state law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue does not comport with [§2 of the Federal Arbitration Act]." Id. As a consequence, "§ 2 of the Act preempts state statutory and case law that treats arbitration agreements differently from any other contract." Cook Chocolate Co. v. Salomon, Inc., 684 F. Supp. 1177, 1182 (S.D.N.Y. 1988).

The metaphor of "equal footing" is expressly embodied in §2, which provides that written agreements "to settle by arbitration a controversy thereafter arising out of such contract . . . shall be valid, irrevocable, and enforceable,

save upon such grounds as exist at law or in equity for the revocation of any contract." (emphasis supplied.) The inherent logic of §2 was succinctly summarized by Judge Weinfeld in Avila Group, Inc. v. Norma J. of Cal., 426 F. Supp. 537, 541 (S.D.N.Y. 1983): "Courts applying federal law under the Arbitration Act have rejected cases that purport to apply special rules and requirements to agreements to arbitrate that are not applicable to other contracts" (footnote omitted).

III

The defendants concede that the regulations single out arbitration agreements: "It is true," defendants note in their Memorandum of Law on Summary Judgment, "that the regulations

themselves apply only to arbitration agreements." Id. at 46. In this sense, the defendants recognize that the securities arbitration regulations are the paradigm of "[a state law principle that takes its] meaning precisely from the fact that a contract to arbitrate is at issue." Id. at 46-47 (quoting Perry v. Thomas, 107 S.Ct. at 2527 n.9).

The defendants justify the regulations, however, by an appeal to another purpose evident in the legislative history of, and case law construing, the Federal Arbitration Act: the concern to implement voluntary agreements to arbitrate.^{8/}

^{8/} The Supreme Court has characterized "[t]he preeminent concern of Congress in passing the Act [as]] enforce[ment of] private agreements into which parties ha[ve] entered." Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 221 (1985).

Alternatively, they rely upon the overall pattern of securities broker regulations, which they contend has effectively modified the Arbitration Act so as to permit their regulations.

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The defendants' appeal to the voluntariness concern of the Federal Arbitration Act is a semantic sleight of hand. There is no question that the Federal Arbitration Act was designed to give full force to the agreement of the parties--a presumptively voluntary undertaking. But, as used by the defendant, the concept of voluntariness addresses the fundamental principles of contract formation upon which questions of validity, revocability, and enforceability of arbitration agreements turn. As used in that way, the concept of voluntariness is not a matter subject

to idiosyncratic rules or definitions. Massachusetts is not free under the Federal Arbitration Act to develop a definition of voluntariness applicable only to the negotiation of arbitration agreements and not to other contracts generally.^{9/}

^{9/} Federal courts have refused to apply similar state voluntariness enhancements specially directed toward arbitration agreements. The Eighth Circuit in Collins Radio Co. v. Ex-Cell-o Corp., 467 F.2d 995 (8th Cir. 1972), declined on preemption grounds to enforce a Texas law which allegedly required the advice and signature of a Texas attorney for each party to the arbitration agreement. In Webb v. R. Rowland & Co., 800 F.2d 803 (8th Cir. 1986), that court declined on preemption grounds to apply a choice of law provision in an arbitration agreement which would have invalidated the agreement for failure to provide a statutorily required special ten-point capital letter notice regarding the binding character of the arbitration provision and would possibly have rendered unenforceable as a contract of adhesion the preprinted arbitration form contract. And in Wydel

(footnote continued)

That, of course, is precisely what the defendants' purported voluntariness

(footnote continued)

Associates v. Thermasol, Ltd., 452 F. Supp. 739 (W.D. Tex. 1978), Chief Judge Spears of the Western District of Texas refused to apply a provision of Texas' version of the Uniform Partnership Act to invalidate an arbitration agreement signed by only one of the partners.

The two cases cited by defendants as examples of singular state treatment of arbitration contract formation countenanced by the federal courts are, respectively, inapposite and nonpersuasive. In Hull v. Norcom, Inc., 750 F.2d 1547 (11th Cir. 1985), the court understood itself to be applying "the general provisions of state contract law to the determination of 'the making of [the] arbitration agreement'." Id. at 1551 (quoting 9 U.S.C. §4). Eassa Properties v. Shearson Lehman Bros. Inc., 851 F.2d 1301 (11th Cir. 1988), disposed of the issue by a brief footnote offering dicta. Finding that a single partner "had been vested with actual authority by the remaining partners to bind the partnership to the arbitration agreements," id. at 1305, the Court had no occasion to consider the effect of Perry and Wydel on its general observation that "state law governs the question of whether [an arbitration] agreement exists in the first instance," id. at 1304 n.7.

enhancements do. There is no general contractual duty in Massachusetts requiring one party to describe fully--or for that matter, at all--the legal effect of a contractual provision to another party with whom the first party proposes to contract.^{10/}

^{10/} Indeed, as the Ninth Circuit noted recently:

We know of no case holding that parties dealing at arm's length have a duty to explain to each other the terms of a written contract. We decline to impose such an obligation where the language of the contract clearly and explicitly provides for arbitration of disputes arising out of the contractual relationship.

Cohen v. Wedbush, Noble, Cooke, Inc., 841 F.2d 282, 287 (9th Cir. 1988); cf. Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc., 806 F.2d 291, 295 n.6 (1st Cir. 1986) ("Despite . . . statement by the Wilko Court that certain investors may operate at a disadvantage vis a vis their more sophisticated brokers, we do not believe that it requires the invalidation of all customer-broker arbitration agreements ab initio") (emphasis in original).

Nor is there any general restriction requiring specific provisions to be "negotiable."^{11/}

^{11/} Massachusetts follows the Restatement position that contracts of adhesion are not unenforceable unless they are unconscionable. See Zapatha v. Dairy Mart, Inc., 381 Mass. 284, 291-95 & 292 n.12, 408 N.E.2d 1370 (1980); Restatement (Second) of Contracts § 208 & comment d. Federal courts have consistently held that agreements to arbitrate are, as a matter of law, not unconscionable. See, e.g., Cohen v. Wedbush, Noble, Cooke, Inc., 841 F.2d at 286 (rejecting conclusion of California state courts that doctrine of unconscionability applies to standard securities arbitration contracts); Pierson v. Dean Witter Reynolds, Inc., 742 F.2d 334, 339 (7th Cir. 1984) (rejecting unconscionability claim in absence of showing that arbitration clause is commercially unreasonable or that plaintiffs lacked reasonable opportunity to understand it); Surman v. Merrill Lynch, Pierce, Fenner & Smith, 733 F.2d 59, 61 n.2 (8th Cir. 1984) (rejecting contention that standard brokerage agreement arbitration clauses are unconscionable); Hurlbut v. Gantshar, 674 F. Supp. 385, 392 (D. Mass. 1987) (holding that agreement to arbitrate securities brokerage disputes before independent, though industry-related, panel of arbitrators pursuant to standard form contract is not unconscionable).

Thus there can be no question that the new arbitration provisions represent a radical departure from the treatment of contracts generally in the State's common law. To be sure, Massachusetts law does contain a variety of idiosyncratic statutory provisions which require special treatment of--and disclosure regarding--certain types of contractual provisions. But the short and sufficient answer to this point is that these provisions--whether styled voluntariness enhancements or not--are the exception which prove the rule. For example, when Massachusetts wanted to require certain disclosures in the consumer credit context, a special truth-in-lending law, Mass. Gen. L. ch. 140D, was necessary, because the Act represented a significant departure from

the law which affects contracts generally in Massachusetts.^{12/} And of course, neither the Massachusetts truth-in-lending provisions, nor any of the other exceptions cited by the defendants as authority, purports to single out arbitration agreements.

The Massachusetts securities arbitration regulations are not concerned with "matters collateral to

^{12/} And even in those circumstances, statutory state law must not interfere with the broader federal scheme. Thus, under the Federal Truth in Lending Act, 15 U.S.C. § 1601 et seq., for example, inconsistent state disclosure requirements are preempted by the federal statute. See, e.g., Truth in Lending: Determinations of Effect on Mississippi, New Jersey, Oklahoma, and South Carolina State Laws, 48 Fed. Reg. 43,672 (1983); Mason v. General Finance Corp. of Va., 542 F.2d 1226 (4th Cir. 1976); Trustees Loan & Discount Co. v. Carswell, 435 So.2d 114 (Ala. Civ. App. 1983); Public Finance Corp. v. Riddle, 83 Ill. App.3d 417, 403 N.E.2d 1316 (1980).

the agreement to arbitrate," such as the procedural issues relating to consolidation of arbitration proceedings dealt with by the First Circuit in New England Energy Inc. v. Keystone Shipping Co., 855 F.2d 1, 4 n.2 (1st Cir. 1988). Rather, the defendants' regulations govern the validity and enforceability of arbitration agreements themselves by establishing standards which, if not met, render the arbitration agreements unenforceable and the unsuccessful makers of those agreements subject to sanction. It is difficult to imagine regulation more central to the arbitral decision.

The defendants' regulations assume this central position by establishing hurdles to the formation and execution of securities arbitration agreements

that are not found in the general contract law of Massachusetts. Because the voluntariness concerns expressed in the unique Massachusetts securities arbitration regulations impose conditions on the formation and execution of arbitration agreements which are not part of the generally applicable contract law of Massachusetts, they cannot be given effect under the Federal Arbitration Act.

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But analysis does not stop with the Arbitration Act alone. As the Supreme Court observed in McMahon:

Like any statutory directive, the Arbitration Act's mandate may be overridden by a contrary congressional command. The burden is on the party opposing arbitration, however, to show that

Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue.

107 S.Ct. at 2337.

Defendants suggest that the role of state Blue Sky law in securities regulation as expressed in the various savings clauses of the federal securities statutes^{13/} provides that contrary command. This argument finds no support in the case law.

The Seventh Circuit in Kroog v. Mait, 712 F.2d 1148 (7th Cir. 1983), cert. denied, 465 U.S. 1007 (1984), rejected the proposition that general savings language which permits concurrent state and federal regulation

^{13/} See, e.g., 15 U.S.C. § 77r (1933 Act); 15 U.S.C. § 78bb(a) (1934 Act); 15 U.S.C. § 80b-18a (Investment Advisers Act of 1940).

of the securities business could sustain a special treatment of arbitration agreements under Wisconsin Blue Sky law. In Kroog, the court declined to indulge a Wisconsin effort to import special arbitration regulation under cover of Blue Sky law. The court found that there was no conflict between Congressional protection of state securities regulation through the savings clauses and the federal law of arbitrability maintained under the Federal Arbitration Act:

[T]he conflict we face is plainly not one of federal arbitration procedures versus Wisconsin substantive securities regulation. The conflict is rather between two procedural demands--one that commands, and the other that prohibits, the arbitration of brokerage contract claims. If the Arbitration Act prevails, Wisconsin substantive securities law remains intact, and would indeed have to be considered by the arbitrator of the dispute here.

Id. at 1153 (emphasis in original).

Needless to say, the Federal Arbitration Act prevailed in Kroog. Thus, even giving full scope to the appropriate role of state Blue Sky law, the savings provisions of the various federal securities statutes do not provide a "contrary Congressional command" permitting state Blue Sky regulators to establish special conditions applicable to arbitration contracts in derogation of the directions of the Federal Arbitration Act. Cf. Osterneck v. Merrill Lynch, Pierce, Ferner & Smith, Inc., 841 F.2d 508, 512 (3d Cir. 1988) (holding preempted § 507 of the Pennsylvania Securities Act when applied to preclude arbitration that falls within the FAA because "[t]he overwhelming weight of precedent militates against . . .

finding that Congress intended to exempt state securities claims from the general command of the [FAA]").

The defendants point to the treatment given arbitrability by the District of Columbia Blue Sky provisions as authority for the Massachusetts arbitration regulations. See Levin v. Dean Witter Reynolds, Inc., 3 Blue Sky L. Rep. (CCH) ¶ 71,812 (D.D.C. 1983). But Levin rested on a Congressional enactment concerned with the District of Columbia as a federal enclave. This provided Congressional authorization for the District's Blue Sky regulation separate from the savings clauses. Thus, the question in Levin was not whether a state legislature could create a Wilko-type exception to §2 of the Arbitration Act, but rather whether

Congress, in enacting the District of Columbia Blue Sky provisions, had done so. Cf. Southland Corp. v. Keating, 465 U.S. at 16 n.11. At issue in Levin was a specific Congressional anti-waiver provision of the type the Supreme Court had found sufficient to override the Arbitration Act in Wilko v. Swan, 346 U.S. 427 (1953). Massachusetts Blue Sky law, however, is not supported by such an independent Congressional enactment.^{14/}

^{14/} For the same reason, the authority granted by Congress to the Commodities Futures Trading Commission to regulate predispute arbitration agreements involving commodities futures, see 17 C.F.R. pt. 180; see generally Inqbar v. Drexel Burnham Lambert Inc., 683 F.2d 603 (1st Cir. 1982), is inapposite. Nothing in that separate authority suggests that Congress has empowered Massachusetts to create similar regulations to govern predispute arbitration agreements for securities disputes.

Moreover, taking a broader view of the authority of securities regulators to address arbitration agreements, it is uncertain whether Wilko itself remains authoritative even on its limited facts. See supra note 1. It is clear that the Supreme Court has had second thoughts about the role of anti-waiver provisions of the type used in Wilko and Levin to override the Federal Arbitration Act.

In part, the careful restriction of Wilko to its specific facts, see Shearson/American Express, Inc. v. McMahon, 107 S.Ct. 2332 (1987), and the pending reconsideration of the narrowed holding itself, see Rodriguez de Quijas v. Shearson/Leahman Bros., Inc., 845 F.2d 1296 (5th Cir.), cert. granted, 57 U.S.L.W. 3347 (U.S. Nov. 15, 1988) (No.

88-385), appear to be premised on supervening Congressional action regarding the arbitrability of securities law claims. As the Supreme Court noted in McMahon, "[s]ince the 1975 amendments to §19 of the Exchange Act [15 U.S.C. §78s, the United States Securities and Exchange] Commission has had expansive power to ensure the adequacy of the arbitration procedures employed by [the national securities exchange and registered securities associations]." 107 S.Ct. at 2341. The Commission is now treading gingerly in this area and is encouraging rulemaking by the affected self-regulatory organizations. See supra note 3.^{15/}

^{15/} Recognizing the limited vitality of Wilko v. Swan after McMahon, the SEC itself has actually withdrawn the

(footnote continued)

Especially given what the Ninth Circuit recently observed is the "virtually plenary authority [of the SEC] over the arbitration procedures adopted by the national securities exchanges and securities association," Cohen v. Wedbush, Noble, Cooke, Inc., 841 F.2d at 286, there is nothing in the pattern

(footnote continued)

mandatory disclosure regulations it had earlier required in connection with securities arbitration agreements. Barely three months after the Supreme Court handed down McMahon, the Commission reversed its previous rulemaking proceeding, see Recourse to the Courts Notwithstanding Arbitration Clauses in Broker-Dealer Customer Agreements, 48 Fed. Reg. 53,404 (1983), and determined that a regulation requiring disclosure of the inapplicability of arbitration agreements to federal securities law claims, 17 C.F.R. § 240.15c2-2, was "no longer appropriate or accurate and, accordingly, should be rescinded." Rescission of Rule Governing Use of Predispute Arbitration Clauses in Broker-Dealer Customer Agreements, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,163 (Oct. 15, 1987).

of Congressional enactments regarding securities regulation which can fairly be read to contemplate a peculiar Massachusetts rule in the regulation of written arbitration agreements concerning the purchase and sale of securities in interstate commerce.^{16/}

^{16/} The SEC declined an invitation I extended to file an amicus brief in this case on grounds that "the underlying preemption claim is based on the Federal Arbitration Act, not the federal securities laws." Letter of SEC General Counsel Daniel L. Goelzer to the Court (Nov. 14, 1988). The stated reason appears less than candid in light of the defendants' reliance on federal securities law for its opposition to the motion for summary judgment. I recognize, however, that various prudential and strategic considerations, including an interest in permitting the case law to ripen and a desire not to become committed even indirectly on an issue as yet unresolved within the agency, may govern the decision whether to file an amicus brief. Cf. P. Irons, The New Deal Lawyers 4-5 (1982). I draw no inferences one way or the other from the lack of a formal expression of the SEC's position on the issues presented to me by this case.

IV

The defendants seek to avoid definitive resolution of this action before the January 1, 1989 effective date for the arbitration regulations. They do so by interposing a motion under Fed. Civ. P. 56(f) requesting further discovery before the plaintiffs' summary judgment motion is resolved.

To be sure, the First Circuit has been careful to note that in looking to the effect the allegedly preemptive state action "will have on the federal scheme set up by Congress," courts must require that "[t]he harm of the state law on the federal scheme . . . be actual, not potential." Palmer v. Liggett Group, 825 F.2d at 626 & n.11.

But nothing in Palmer, or the line of cases it represents, provides justification for delay in entering

summary judgment for the defendants. The grounds for preemption are as apparent here as they were in Palmer. The actual harm inflicted on the federal scheme for arbitration by the Massachusetts securities arbitration regulations is manifest in the conditions they impose on the validity and enforceability of securities dispute arbitration agreements, conditions not generally applicable to contracts in the Commonwealth. No further factual development is necessary to deal with the legal consequences of that circumstance.

In pressing this motion, the defendants have adopted seemingly inconsistent official positions. After conducting what they presumably consider sufficient proceedings to have a

rational basis for promulgating the Massachusetts securities arbitration rules, the defendants now pose as incapable of demonstrating facts sufficient to defeat the plaintiffs' motion because the effect of the regulations is alleged by them to be in dispute. Given this purported inability to join issue with plaintiffs' motion, the defendant contend that no further action on their regulations--now that they have put them in place--should be taken until additional inquiry--which the defendants themselves did not feel obliged to undertake before promulgating the regulations--has been completed.

The defendants' position is laid out in a highly artificial manner. As a matter of semantics, they contend that the regulations are not addressed to the

validity or enforceability of arbitration contracts. This contention can be maintained only by assuming that no provision of the state law other than one directly governing contract validity or enforceability comes within the preemptive reach of the Arbitration Act. But, as Palmer suggests, indirect regulation through a system of sanctions can be every bit as "potent [a] method of governing conduct and controlling policy" as direct proscriptions regarding arbitration. Cf. id. at 627-28 (quoting San Diego Bldg. Trades Council v. Garmon, 359 U.S. 236, 247 (1959)). Justice Holmes, while sitting on the Massachusetts Supreme Judicial Court, described the system of sanctions as the essence of the law. "If you want to know the law and nothing else, you

must look at it as a bad man, who cares only for the material consequences which such knowledge enables him to predict " O.W. Holmes, The Path of the Law, in Collected Legal Papers 167, 171 (1920).

The material consequences are plain here. Should a securities broker attempt to deal with arbitration agreements in Massachusetts after January 1, 1989, in the manner applicable to Massachusetts contracts generally, she will find herself labelled "dishonest" and "unethical" and have her license to do business put in jeopardy. Indeed, as noted above, a contract in violation of the Massachusetts securities arbitration regulations is, as a matter of Massachusetts Blue Sky law,

unenforceable. Mass. Gen. L. ch. 110A, § 410(f). Massachusetts could not have been clearer in its intention--despite its oblique means of execution--to make securities arbitration contracts subject to different rules regarding validity and enforceability from those that govern other contracts. It takes no further factual development to reach that conclusion.

The specific additional discovery defendants seek does not appear to address any genuine issues of material fact. The defendant Guthary in his Third Affidavit submitted in support of the defendants' Rule 56(f) motion seek to develop additional information on "the marginal impact of the arbitration regulations on individualization [of customer accounts]," ¶ 4; whether "a

two-tiered commission scheme" to reflect different costs of pre-dispute and non-predispute arbitration contracts "could be implemented in ordinary compliance and training materials," ¶ 5; "the degree to which negotiation over arbitration clauses currently impairs broker-customer relationships," ¶ 6; "how often securities customers who do not sign arbitration agreements currently choose arbitration over litigation in the absence of a pre-dispute agreement," ¶ 8; and "the application of plaintiffs' commodities experience to securities" and "how many commodities customers arbitrate even in the absence of a pre-dispute arbitration agreement," ¶ 9.

None of these areas of inquiry--even if likely to produce some genuine

dispute, a matter defendants do not address--concerns any issues material to my determination. Thus defendants' motion pursuant to Rule 56(f) will be denied. See generally Paterson-Leitch Co. v. Massachusetts Mun. Wholesale Elec. Co., 840 F. 2d 985, 988-89 (1st Cir. 1988); Taylor v. Gallagher, 737 F.2d 134, 137 (1st Cir. 1984).

V.

Although I am prepared to grant plaintiffs' motion for summary judgment in this matter as a predicate to entry of the dispositive order, an excess of caution prompts me to offer in the alternative reasons for entering an interim order of preliminary injunction invalidating the Massachusetts securities arbitration regulations, should entry of summary judgment be

ruled premature because of the denial of defendants' Rule 56(f) motion.

In response to my scheduling conference observation that denial of the motion for summary judgment would not constitute a final order permitting appeal, plaintiffs filed a motion for a preliminary injunction in order to have a serviceable back-up vehicle for immediate appeal. If called upon to rule in this matter only on an interim basis, I would grant such a motion, as plainly satisfying the traditional four-pronged inquiry necessary to support a summary judgment determination in the First Circuit. See generally Planned Parenthood League of Mass. v. Bellotti, 641 F.2d 1006, 1009 (1st Cir. 1981).

A. Success on the Merits

My treatment of the motion for summary judgment makes clear my views regarding the plaintiffs' all but certain success on the merits. To the degree that additional positive findings of an adverse effect on arbitration are necessary, the materials presented by the plaintiffs in support of their summary judgment motion supply such additional evidence.

The experience of certain of the plaintiffs with commodities accounts, for which pre-dispute arbitration agreements are subject to special disclosure rules and may not be made a condition of doing business, indicates that a significant number of commodity accounts customers decline to enter into such agreements. In the experience of

plaintiff Shearson Lehman Hutton, 34 percent fewer commodities customers execute pre-dispute arbitration agreements than do securities customers. Affidavit of Theodore A. Krebsbach ¶ 9. A random survey by plaintiff PaineWebber found that 58 percent of commodities account customers refuse arbitration under the non-mandatory scheme. Affidavit of John A. Borgese ¶ 3.

To the degree that the Massachusetts securities arbitration regulations are modelled on the CFTC arbitration regulation, 17 C.F.R. pt. 180,^{17/}

^{17/} It should be noted that the CFTC regulations are significantly more precise than the Massachusetts rules. The required disclosure is set forth in the CFTC regulations expressly. 17 C.F.R. § 180.3(b)(4)-(6). And rather than requiring negotiability, the CFTC regulations do not permit a pre-dispute arbitration agreement to be a condition of opening a commodities account. 17 C.F.R. § 180.3(b)(1).

the affidavits submitted in support of a preliminary injunction demonstrate that the special Massachusetts securities arbitration contract rules will have a limiting effect on the formation of arbitration agreements.

B. Harm to Plaintiffs

The harm to the plaintiffs is irreparable if enforcement of the regulation is not enjoined. The patterns and practices of contract formation regarding securities arbitration will, of course, need costly revision during the pendency of the litigation in the absence of an injunction. More significantly, the evidence demonstrates that the costs of dispute resolution itself will increase

in direct proportion to the number of claims in which arbitration is rejected. These are costs which cannot be recovered from the defendant state officials. Cf. National Tank Truck Carriers, Inc. v. Burke, 608 F.2d 819, 824 (1st Cir. 1979).

Moreover, they are substantial costs. A report prepared by Deloitte Haskins & Sells for the New York Stock Exchange indicates that on average the legal costs to brokerage firms from arbitration are \$12,000 less than the legal costs for litigation in court. Affidavit of Paul J. Dubow ¶ 11. In the aggregate, while the extent of the plaintiffs' monetary loss is difficult if not impossible to calculate with any precision, it appears reasonable to assume that imposition of the

Massachusetts securities arbitration regulations will add between one-quarter to one-half million dollars annually to the legal fees of certain of the plaintiffs.

C. Harm to Defendants

The harm to the defendants if their regulations are suspended before this litigation reaches conclusion is modest and highly speculative at best. The defendants are in the peculiar posture of defending a set of regulations the effect of which they contend (by their Fed. R. Civ. P. 56(f) submissions) they are not now in a position to describe by admissible evidence. If additional evidence is necessary to demonstrate the interference of these regulations with

the Federal Arbitration Act - - a proposition I do not accept but which the defendants forward - - then a further period of time during which the impact of the singular Massachusetts securities arbitration regulations is studied and analyzed through discovery and full trial would cause little harm. That is the general approach taken by the Securities and Exchange Commission, see supra note 3, the federal agency the Courts recognize as having virtual plenary power to govern the arbitration contracts of brokers, see Cohen v. Wedbush, Noble, Cooke, Inc. 841 F.2d at 286.

The reasons adduced by the plaintiffs for special securities arbitration rules do not demonstrate that there will be any significant harm

if the rules are held in suspension pending a definitive determination of the merits of this case. The suggestion that litigation over the unconscionability of mandatory pre-dispute arbitration agreements will be reduced is hardly persuasive. The law that such agreements are not unconscionable per se is so consistent that a contention that they are should not require any court to linger long over the issue in any event.

To be sure, disclosure as a general proposition is difficult to fault. Certainly, full and fair disclosure is the zeitgeist of securities regulation. A case can be made that the fuller the disclosure the better. But the defendants have not undertaken to describe with particularly what precise

disclosure is necessary. Unlike the CFTC disclosure requirements, see supra note 17, the Massachusetts securities arbitration regulations give no direction about what full disclosure of the "legal effects" of pre-dispute arbitration agreements will entail. The disclosure concerns of the defendants have not been crystallized. In the unformed state in which they are presented by the Massachusetts securities arbitration regulations, these generalized concerns for disclosure do not lend immediacy to the speculative claim of harm to the defendants if interim injunctive relief is granted.

The defendants' interest in "negotiability" is no more compelling as a basis for finding injunctive harm.

The defendants speak broadly of unidentified benefits and inducements that brokers will be encouraged to offer to secure pre-dispute arbitration agreements with customers. To the degree these benefits and inducements are specified, however, they seem to center around commission rates. This potential impact on commission rates involves a secondary effect of the Massachusetts securities arbitration regulations which, far from suggesting harm to the defendants, raises troubling questions about the anticipated regulatory scope of defendants' treatment of arbitration by brokers and their customers.

The defendant Guthary, while professing to believe that the effect of his regulations on the plaintiffs'

business as evidenced in plaintiffs' affidavits is "speculative, without substantive factual support," offers his own "opinion [that] it would be practical for brokers to adopt a two-tiered commission scheme" to compensate for the cost differential between arbitrable customer accounts and those which are not. Third Affidavit of Barry C. Guthary ¶¶ 2, 5. This reference to the influence the Massachusetts securities arbitration regulations will have on commission rate structure suggests insinuation by local Blue Sky authorities into brokerage commission rate making, an area in which the SEC exercises full authority. See generally 17 C.F.R. § 240.19b-3; Adoption of Securities Exchange Act Rule 19b-3, Exchange Act Release No. 11,203,

[1974-75 Transfer Binder] Fed. Sec. L.
Rep. (CCH) ¶ 80,067, at 84,955-57 (Jan.
23, 1975).

Moreover, it is by no means clear that such a two-tiered rate structure will be of economic benefit to customers. To the degree that arbitration constitutes a more economical form of dispute resolution, it may be anticipated that regulations which discourage arbitration will have the effect of raising commission rates - - at least on non-arbitration contracts - - to absorb the costs.^{18/} It is

^{18/} Of course, to the degree that individual brokerage firms perceive a demand for non-arbitration customer agreements, it may also be assumed that such agreements will be offered--and priced accordingly--by some brokers irrespective of whether state regulations encourage such agreements or not.

difficult to conceive what harm there will be to defendants if an interim injunction prevents (at least until completion of this litigation) institution of the "two-tier commission scheme" contemplated by defendants.

D. Public Interest

With respect to the question of the public interest, the Congress and the Supreme Court have offered the definitive word. In enforcing the "emphatic federal policy in favor of arbitral dispute resolution" implemented by the Federal Arbitration Act, Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. at 631, the Supreme Court described the benefits of arbitration favorably in the

antitrust context:

[A]daptability and access to expertise are hallmarks of arbitration. The anticipated subject matter of the dispute may be taken into account when the arbitrators are appointed, and arbitral rules typically provide for the participation of experts either employed by the parties or appointed by the tribunal. Moreover, it is often a judgment that streamlined proceedings and expeditious results will best serve their needs that causes parties to agree to arbitrate their disputes; it is typically a desire to keep the effort and expense required to resolve a dispute within manageable bounds that prompts them mutually to forgo access to judicial remedies.

Id. at 633 (footnote omitted.)

This is a form of dispute resolution Congress intended to facilitate in the securities context as well, where the Supreme Court has recently held that "agreements to arbitrate Exchange Act claims [are] 'enforce[able]' . . . in

accord with the explicit provisions of the Arbitration Act'." McMahon, 107 S.Ct at 2343 (quoting Scherk v. Alberto-Culver Co., 417 U.S at 520).

The evidence adduced in plaintiffs' affidavits in support of a preliminary injunction tends to show that arbitration is a benefit both to public customers and to brokers like plaintiffs. Customer legal expenses are likely to mirror broker legal expenses; the finding of the Deloitte Haskins & Sells study that broker-dealer legal expenses are significantly less in arbitration than in court litigation may accordingly also be interpreted as predicting relative economic benefit favoring arbitration for the customer.

The Deloitte study shows that customers receive on average a significantly higher percentage of their original claims by pursuing their disputes in arbitration (19.57 percent of claim recovered) then in court litigation (2.60 percent of claim recovered). Affidavit of Paul J. Dubow

¶ 11. The plaintiff Dean Witter reports an even more favorable recovery for customer claimants who pursued arbitration in cases completed in 1987; for those Dean Witter claimants, arbitration yielded 37 percent of total compensatory damages sought, compared with 17.02 percent of such damages for those pursuing litigation. Id. ¶ 12.

In short, on the evidence before me it appears that court litigation affords customers the opportunity to pay more in

legal costs to get less in recovery. Moreover, this opportunity will apparently be preserved only after paying for brokerage services at the higher level of the "two-tiered commission scheme" the defendant Guthary opines will be the likely industry response to the Massachusetts securities arbitration regulations.

Finally, it should be noted that shifting securities disputes from arbitration to court litigation will bring these disputes to a federal court system already overburdened by a heavy caseload. It is a rare securities claim which cannot be styled as a federal question under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), 17 C.F.R. § 240.10b-5. Such a case can be brought in the federal

courts without regard to the amount in controversy under 28 U.S.C. § 1337 and 15 U.S.C. § 78aa. It would be ironic - - and hardly in furtherance of the public interest in efficient federal courts - - if such actions by non-institutional customers were now to come into federal court in greater numbers at precisely the time that Congress has moved to limit smaller claims in federal court litigation by raising to \$50,000 the amount in controversy minimum for diversity action. Judicial Improvements and Access to Justice Act, Pub. L. No. 100-702, § 201, 102 Stat. 4642 (1988) (to be codified at 28 U.S.C. § 1332).

On the evidence before me, I find significant functional benefits to the public generally, and to the structuring

of efficient and economic dispute resolution, if the likely limits on securities dispute arbitration proposed through the Massachusetts securities arbitration regulations are deferred pending conclusion of this case on the merits.

E. Conclusion

Evaluating these four prongs to preliminary injunction analysis inter se, I conclude that given the plaintiffs' clear likelihood of ultimate success on the merits of their preemption claim, the prospect of substantial irreparable harm to the plaintiffs if the injunction is not granted--as balanced against the potential for minimal harm to the

defendants if the injunction is granted--and the public interest on the part of both customers as a class and the public at large in furthering the emphatic national policy in favor of the efficiencies of arbitral dispute resolution, an interim injunction staying implementation of the Massachusetts securities arbitration regulations until conclusion of this litigation would be appropriate.

VI

I fully recognize the importance of permitting states to experiment with reform in economic regulation. Federal courts must be reticent about interposing their powers to prevent such experimentation. The principles were

stated with plain spoken eloquence by
Justice Brandeis:

To stay experimentation in things social and economic is a grave responsibility. Denial of the right to experiment may be fraught with serious consequences to the Nation. It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.

New State Ice Co. v. Liebmann, 285 U.S.
262, 311 (1932) (Brandeis, J.,
dissenting).

This reticence has been given expression by the First Circuit in the preemption context. The court has noted that the federal courts have an obligation to control preemption doctrine for two basic reasons rooted in principles of federalism and separation

of powers fundamental to our system of government. First, "diffusion of power to the states is said to further democracy," and second, "a finding of no preemption is regarded as preferable because Congress can overrule it by appropriate legislation, while a finding of preemption cannot be changed by the states." Agency Rent-A-Car, Inc. v. Connolly, 686 F.2d 1029, 1038 (1st Cir. 1982).

The key, however, is Congress--and here, the agency Congress has selected for supervision of securities arbitration: the United States Securities and Exchange Commission. Where Congress has been heard to have spoken as emphatically as it has been heard by the Supreme Court concerning the broad preemptive intent of the

Federal Arbitration Act in the area of securities disputes, any modification of that intent must come from Congress itself. The courts cannot evade the principles established by broadly preemptive legislation in order to permit state experimentation. Until Congress establishes exceptions to the Federal Arbitration Act permitting states to adopt singular legal principles for the formation and execution of arbitration agreements, state law provisions like the Massachusetts securities arbitration regulations cannot stand.

Finding that the Massachusetts securities arbitration regulations disturb too much the Congressionally declared scheme of treating the formation, validity, and enforceability

of arbitration contracts in the same manner as contracts generally, I conclude that I must order the Massachusetts securities arbitration regulations displaced by the force of preemption and allow the plaintiffs' motion for summary judgment.

Accordingly, it is hereby ORDERED that a judgment enter

1. declaring that the Massachusetts securities arbitration regulations, Mass. Reg. Code tit. 950, § 12:204(a)(2)(G)1.a.-c. are preempted by the Federal Arbitration Act, 9 U.S.C. § 1 et seq.; and

2. enjoining the defendants from enforcing the Massachusetts securities arbitration regulations in any manner.

Douglas P. Woodlock
United States District Judge

APPENDIX D

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

CIVIL ACTION NO. 88-2153-WD

SECURITIES INDUSTRY ASSOCIATION,
et al.,

Plaintiffs,

v.

MICHAEL J. CONNOLLY, Secretary of State,
et al.,

Defendants.

JUDGMENT

December 19, 1988

In accordance with the Memorandum
and Order for Judgment issued this day,

it is hereby ORDERED, ADJUDGED and
DECREED

1. That the Massachusetts
securities arbitration regulations,
Mass. Reg. Code tit. 950,
§ 12:204(a)(2)(G)1.a.-c., are violative
of the Supremacy Clause of the
Constitution of the United States, art.
VI, cl. 2, in that they are preempted by
the Federal Arbitration Act, 9 U.S.C.
§ 1 et seq., and

2. That the defendants shall
refrain from enforcing the Massachusetts
securities arbitration regulations in
any manner.

/s/
Douglas P. Woodlock
United States District Judge



No. 89-894

2

Supreme Court, U.S.
FILED

DEC 27 1989

JOSEPH F. SPANIOL, JR.
CLERK

**In the
Supreme Court of the United States**

OCTOBER TERM, 1989.

MICHAEL J. CONNOLLY, SECRETARY
OF STATE, AND BARRY C. GUTHARY,
DIRECTOR, MASSACHUSETTS SECURITIES DIVISION,
PETITIONERS,
v.

SECURITIES INDUSTRY ASSOCIATION, DEAN WITTER
REYNOLDS INC., DONALDSON, LUFKIN & JENRETTE
SECURITIES CORPORATION, DREXEL BURNHAM
LAMBERT INCORPORATED, FIDELITY BROKERAGE
SERVICES, INC., KIDDER PEABODY & CO.
INCORPORATED, MERRILL LYNCH, PIERCE,
FENNER & SMITH INCORPORATED, PAINWEBBER
INCORPORATED, PRUDENTIAL-BACHE SECURITIES
INC., SHEARSON LEHMAN HUTTON INC.,
AND SMITH BARNEY, HARRIS UPHAM & CO.
INCORPORATED,
RESPONDENTS.

**RESPONDENTS' BRIEF IN OPPOSITION TO PETITION
FOR A WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE FIRST CIRCUIT**

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Question Presented for Review

Whether state regulations which apply only to arbitration agreements, and which impose different and more onerous formation rules for arbitration contracts than pertain to contracts generally, are preempted by the Federal Arbitration Act.

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No. 89-894
In the
Supreme Court of the United States

OCTOBER TERM, 1989

**MICHAEL J. CONNOLLY, SECRETARY
OF STATE, AND BARRY C. GUTHARY,
DIRECTOR, MASSACHUSETTS SECURITIES DIVISION,
PETITIONERS,**

v.

**SECURITIES INDUSTRY ASSOCIATION, DEAN WITTER
REYNOLDS INC., DONALDSON, LUFKIN & JENRETTE
SECURITIES CORPORATION, DREXEL BURNHAM
LAMBERT INCORPORATED, FIDELITY BROKERAGE
SERVICES, INC., KIDDER PEABODY & CO.
INCORPORATED, MERRILL LYNCH, PIERCE,
FENNER & SMITH INCORPORATED, PAINWEBBER
INCORPORATED, PRUDENTIAL-BACHE SECURITIES
INC., SHEARSON LEHMAN HUTTON INC.,
AND SMITH BARNEY, HARRIS UPHAM & CO.
INCORPORATED,
RESPONDENTS.**

**RESPONDENTS' BRIEF IN OPPOSITION TO PETITION
FOR A WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE FIRST CIRCUIT**

**Respondents respectfully pray that the petition for a writ of
certiorari to review the decision of the United States Court of
Appeals for the First Circuit dated August 31, 1989 be denied.**

Statement of the Case

The regulations at issue declare it to be a “dishonest or unethical practice[]” for a brokerage firm to:

1. require a customer to execute an arbitration agreement as a “non-negotiable precondition” to opening or transacting business in a securities account; or
2. request that a customer enter into an arbitration agreement without disclosing that the customer cannot be required to execute the agreement and without “fully and fairly” disclosing the “legal effects” of the arbitration agreement.

950 C.M.R. § 12.104(g)(1)(a)-(c).¹

The Secretary of State may deny, suspend, or revoke the registration of a broker-dealer which engages in a “dishonest or unethical” practice. Mass. Gen. Laws Ann. ch. 110A, § 204 (1989 Supp.). It is unlawful to transact business in Massachusetts as a broker-dealer firm without registration. *Id.* at § 201. The Regulations effectively impose special rules on the formation of arbitration agreements between brokers and customers — rules that do not burden the making of contracts generally.

It is undisputed that broker-customer agreements “evidenc[e] . . . transactions involving commerce” and are typically in writing, and thus subject to the Federal Arbitration Act, 9 U.S.C. § 2 (the “FAA”). *See generally Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985).²

¹ The Regulations are appended to the Opinion of the Court of Appeals in the Petition for Certiorari at 49a-52a (hereinafter, the “Regulations”). The Opinion is found in the Petition at 1a-48a.

² The FAA, at 9 U.S.C. § 2, provides:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or trans-

The Court of Appeals for the First Circuit held that the Regulations were preempted "as a matter of law [because they] actually conflict with the FAA and the federal policy therein." Opinion at 41a. Certiorari is sought from this judgment, rendered August 31, 1989.

Reasons Why a Writ of Certiorari Should Not Be Granted

I. THE FIRST CIRCUIT DECISION IS CONSISTENT WITH APPLICABLE DECISIONS OF THE COURT.

A. *This Court Has Provided Considerable Guidance on the Proper Construction of the Federal Arbitration Act.*

In a long line of cases, this Court has made it clear that Congress intended, in the FAA, "to provide for the enforcement of arbitration agreements within the full reach of the Commerce Clause." *Perry v. Thomas*, 482 U.S. 483, 490 (1987). What that means has been fleshed out in some nine decisions construing the FAA rendered by the Court over the past fifteen years.³

action, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

³ *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 109 S. Ct. 1917 (1989); *Volt Information Sciences, Inc. v. Board of Trustees*, 109 S. Ct. 1248 (1989); *Perry v. Thomas*, 482 U.S. 483 (1987); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985); *Southland Corp. v. Keating*, 465 U.S. 1 (1984); *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1 (1983); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974).

Four of these decisions came down within the past three years,⁴ and three specifically addressed preemption of state law under the FAA,⁵ including one, *Perry*, that speaks directly to the issue in this case.

This body of Supreme Court case law applied by the Court of Appeals establishes the Court's "current strong endorsement of the federal statutes favoring [arbitration]." *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 109 S. Ct. 1917, 1920 (1989). Recognizing an emphatic "federal policy favoring arbitration," *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. at 24 (1983), the Court has found the arbitral process competent to handle claims of virtually every kind: *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974) (international contract disputes); *Byrd*, 470 U.S. at 213 (state law claims); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985) (antitrust disputes); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (claims under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. § 1961 *et seq.*); and *Rodriguez de Quijas*, 109 S. Ct. at 1917 (claim under § 12(2) of the Securities Act of 1933, 15 U.S.C. § 771(2)). Reading the Act to require that "we rigorously enforce agreements to arbitrate," the Court has resolved "any doubts concerning the scope of arbitrable issues . . . in favor of arbitration," whatever "the problem at hand." *Moses H. Cone Memorial Hospital*, 460 U.S. at 24-25.

⁴*Rodriguez de Quijas*, 109 S. Ct. at 1917; *Volt Information Sciences*, 109 S. Ct. at 1248; *McMahon*, 482 U.S. at 220; *Perry*, 482 U.S. at 483.

⁵*Volt Information Sciences*, 109 S. Ct. at 1248; *Perry*, 482 U.S. at 483; *Southland Corp.*, 465 U.S. at 1.

B. *The Court of Appeals Followed the Teachings of this Court on the Preemptive Effect of the FAA.*

Petitioners cannot demonstrate that the First Circuit decision, striking down Regulations which imposed far more demanding standards on the formation of arbitration contracts than are imposed by the general law of contracts in the Commonwealth of Massachusetts, is in conflict with applicable decisions of this Court. Sup. Ct. R. 17.1(c). In *Southland Corp. v. Keating*, 465 U.S. 1, 11 (1984), the Court declared that "the broad principle of enforceability is [not] subject to any additional limitations under state law." The Court underscored that Congress "contemplated a broad reach of the Act, unencumbered by state-law constraints." *Id.* at 13.

1. No conflict is created by the fact that the Regulations apply only to securities brokers.

A California law requiring a judicial forum only for franchise disputes was held preempted given Congressional intent "to foreclose state legislative attempts to undercut the enforceability of arbitration agreements." *Southland Corp.*, 465 U.S. at 16. Another California statute, purporting to require "that litigants be provided a judicial forum for resolving wage disputes," was held to be preempted in *Perry*, 482 U.S. at 491.

These cases lead directly to the First Circuit holding that Massachusetts cannot encumber the formation of securities arbitration agreements for asserted reasons of investor protection. See Opinion at 22a-23a ("At the very least, . . . enmity [toward arbitration], however manifested in state law, is preempted."). Petitioners nevertheless purport to find a "conflict" on the grounds that a state is free to single out certain industries for "protection" against arbitration if it is in an "established area of State concern." Petition at 22. Why "the conduct of securities brokers" but not employers is an area of

concern justifying an extraordinary deviation from the preemption guidelines articulated in *Southland* is never explained. As this Court has held, nothing in the Securities Exchange Act of 1934 or the Securities Act of 1933 justifies antagonism toward arbitration agreements affecting securities.⁶ See *McMahon*, 482 U.S. at 220 and *Rodriguez de Quijas*, 109 S. Ct. at 1917.

2. The First Circuit decision is consistent with applicable decisions of this Court because the Regulations single out arbitration agreements for special treatment.

The Court of Appeals' holding that the FAA preempts state contract formation rules which single out arbitration agreements adheres to this Court's explanation in *Perry* of the role of state law under the FAA: "[s]tate law, whether of legislative or judicial origin, is applicable *if* that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally. A state law principle that takes its meaning from the fact that a contract to arbitrate is at issue does not comport with this requirement of § 2." 482 U.S. at 492-93 n.9 [citation omitted]. As if this language did not exist, petitioners seek certiorari to determine the extent of state authority to subject arbitration to *differential* regulation. See Petition at 32 (issue is whether states have authority to adopt rules for arbitration "in lieu of . . . traditional contract law doc-

⁶For a state to claim some special power to regulate arbitration agreements entered into with securities brokers is particularly ironic since the Securities and Exchange Commission (SEC), as this Court has observed, has "broad authority to oversee and regulate . . ." arbitrations relating to customer disputes, *McMahon*, 482 U.S. at 233-34. After respondents submitted their brief in the Court of Appeals, the SEC explicitly chose not to adopt rules similar to those at issue here. See 54 Fed. Reg. 21,144; 21,154 (May 16, 1989) cited at Petition at 20. The SEC expressly looked to "competitive forces" in the marketplace. Rather, the SEC has approved rules proposed by industry Self-Regulatory Organizations, providing for appropriate disclosures regarding the inclusion of arbitration clauses in customer agreements. *Id.*

trines"). Because the Regulations apply only to arbitration agreements, they decidedly take their "meaning from the fact that a contract to arbitrate is at issue." The Court of Appeals' holding that Massachusetts may require bargaining in the formation of arbitration agreements only if bargaining is required in the formation of contracts generally flows inexorably from *Perry*.⁷

Southland Corp. also makes it clear that only "general contract defenses such as fraud . . ." can be raised against the formation or enforcement of an arbitration agreement. 465 U.S. at 16 n.11 (emphasis added). The Court reiterated in *Volt Information Sciences, Inc. v. Board of Trustees*, 109 S. Ct. 1248, 1254 (1989), that only "general state-law principles of contract interpretation" can be applied to arbitration agreements falling within the purview of the FAA.

This rule of generality, which controlled the Court of Appeals' preemption analysis, proceeds from the recognized purpose of the Act "to place an arbitration agreement 'upon the same footing as other contracts, where it belongs' . . ." *Byrd*, 470 U.S. at 219, citing H.R. Rep. No. 96, 68th Cong., 1st Sess. 1 (1924). See also *Volt Information Sciences*, 109 S. Ct. at 1255. The "equal footing" policy, in turn, reflects a Congressional intent to root out longstanding judicial hostility to arbitration. *Byrd*, 470 U.S. at 219-20. The insistence that only *general* state law govern arbitration ensures that states cannot, in the guise of promoting particular policies, "wholly eviscerate congressional intent to place arbitration agreements 'upon the same footing as other contracts.'" *Southland Corp.*, 460 U.S. at 16 n.11, citing H.R. Rep. No. 96, 68th Cong. 1st Sess. 1 (1924).

⁷ Petitioners appear to argue that this case poses the question as to whether a state may adopt different rules for consumer contracts. Petition at 24. The ability of a state to distinguish between consumer and non-consumer contracts is not at issue because the Regulations apply only to arbitration clauses, not to all clauses in consumer contracts.

The fact that the Regulations are argued to be a “prophylactic” against “‘fraud or overwhelming economic power,’” Petition at 36, does not, as the Court of Appeals held, override the requirement that the grounds for disfavoring an arbitration agreement must be the same as those for any contract. What should be beyond dispute at this time is that no state may single out arbitration for special regulation.⁸ If “bargaining” is deemed by a state to be vital to “voluntariness,” particularly in a consumer setting, then presumably a state, consistent with the FAA, could prohibit all clauses in standard form consumer contracts, including, but not limited to, arbitration clauses. Massachusetts did not do that. Nor did it declare all contracts of adhesion presumptively unenforceable. In *Perry*, this Court noted that “unconscionability,” a formation issue, is governed by the principle that a state may not create special rules applicable only to arbitration contracts. 482 U.S. at 493 n.9.

Petitioners note, but fail to deal with, language in *McMahon* that “[a]bsent a well-founded claim that an arbitration resulted from the sort of fraud or excessive economic power that ‘would provide grounds ‘for the revocation of any contract,’ [citation omitted] the Arbitration Act ‘provides no basis for disfavoring agreements to arbitrate statutory claims by skewing the otherwise hospitable inquiry into arbitrability.’” 482 U.S. at 226. Petition at 44. Of course, parties need not arbitrate, just as they need not carry out other contract terms, when they have not agreed to do so. No case suggests that, in the name of “enhancing voluntariness,”⁹ a state may create onerous require-

⁸ This case does not present an issue of a state’s authority to regulate on subjects collateral to the formation, construction, or validity of arbitration agreements.

⁹ Petitioners argue that the Regulations harmonize with the purposes of the FAA because federal law “was plainly intended to facilitate *consensual* arbitration” and “the Massachusetts regulations are faithful to the federal policy . . .” Petition at 42, 44-45. Burdening arbitration agreements with special

ments applicable only to arbitration agreements. Indeed, the case law is to the contrary. Whether arbitration agreements are "adhesive in nature" or "unconscionable" is to be governed by the rules generally applicable to contracts. Only a "factual showing" which establishes grounds "for the revocation of any contract" justifies concluding that an arbitration agreement was the product of unequal bargaining power. *Rodriguez de Quijas*, 109 S. Ct. at 1921; *Perry*, 482 U.S. at 492-93 n.9.¹⁰

A regulatory approach treating a certain class of arbitration agreements as inherently coercive too closely resembles "state legislative attempts to undercut the enforceability of arbitration agreements." *Southland Corp.*, 465 U.S. at 16. Had the First Circuit shown latitude for a legal "prophylactic" which singles out arbitration agreements, it would have acted contrary to applicable decisions of this Court.¹¹

procedures, grafted on top of existing law ensuring voluntariness and protecting contracting parties against fraud and duress, can hardly be described as a goal of the FAA. *Cf. Volt Information Sciences*, 109 S. Ct. at 1254. In any event, because the Regulations clash with the "equal footing" policy of the FAA, *id.* at 1255, they are preempted. *See Michigan Canners & Freezers Ass'n v. Agricultural Marketing & Bargaining Board*, 467 U.S. 461, 477 (1984).

¹⁰ Nor does the general contract law of Massachusetts afford a basis for concern that standard form contracts are systematically the product of coercion or overreaching. *See, e.g., Carpenter v. Suffolk Franklin Sav. Bank*, 370 Mass. 314, 327, 346 N.E.2d 892, 900 (1976). On the contrary, assent to a contract is presumed to be a "conscious choice" in the absence of fraud or undue influence. *See Markell v. Sidney B. Pfeiffer Foundation, Inc.*, 9 Mass. App. Ct. 412, 440, 402 N.E.2d 76, 93 (1980).

¹¹ *Mitsubishi Motors* and *Rodriguez de Quijas* likewise dispose of petitioners' issue as to "whether the States have any authority to ensure that arbitration agreements are entered into knowingly and voluntarily, in lieu of case by case adjudications under traditional contract law doctrines." Petition at 32. *Mitsubishi Motors* "forbids indulgent presumptions as to systematic overreaching in the investor-broker context." *Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, 806 F.2d 291, 295 and n.6 (1st Cir. 1986). Lower courts have consistently rejected claims that standard form contracts entered between securities brokers and customers are unconscionable or contracts of adhesion. *See Adams v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 888 F.2d 696 (10th

3. The Court of Appeals followed applicable decisions of this Court in concluding that the Regulations are preempted whether or not they directly prohibit enforcement.

The Court of Appeals followed settled law when it concluded that the Regulations are preempted regardless of whether they trench directly on enforceability. *See* Opinion at 36a-37a. The federal policy favoring arbitration can be "undercut" by discriminatory state rules all the more effectively if the chosen sanction is license suspension. *See generally Southland Corp.*, 465 U.S. at 16. "The power to suspend a license is much more than a shift in costs; it is the economic equivalent of the death penalty." Opinion at 42a.¹²

Cir. 1989); *Cohen v. Wedbush, Noble, Cooke, Inc.*, 841 F.2d 282 (9th Cir. 1988).

¹² Petitioners argue that the Regulations did not conflict with the purposes of FAA because they did not limit enforcement of arbitration agreements. Petition at 36. The Court of Appeals characterized that claim as "open to considerable doubt" and stated that, as the District Court had held, the Blue Sky Act, Mass. Gen. Laws Ann. ch. 110A, would likely render non-conforming agreements unenforceable. *See* Opinion at 36a-37a, n.7, *citing* 703 F. Supp. at 149. The Court of Appeals also cited "hornbook law that one who violates a licensing statute — which, as here, is not a revenue measure, but a public-protection statute — is generally not allowed to enforce the contract." *Id.* at 37a, n.7 This accords with settled Massachusetts law that "it is against public policy that the court should be called upon to enforce contracts the parties have been expressly or impliedly forbidden by law to make. . . ." *Nussenbaum v. Chambers & Chambers, Inc.*, 322 Mass. 419, 422, 77 N.E.2d 780 (1948). In any event, certiorari is inappropriate to review whether the Regulations limit the enforceability of arbitration agreements as a matter of state law. *See* note 14, *infra*. Moreover, the Court of Appeals correctly interpreted this Court's opinions as supporting the proposition that the draconian sanction of license suspension is just as impermissible a means of effectuating hostility to arbitration as direct limitations on enforceability.

4. The First Circuit correctly held that the Regulations conflict with the equal footing policy of the FAA.

Petitioners' contention that the First Circuit impermissibly encouraged resort to arbitration, Petition at 40, ignores the holding of the Court of Appeals, as well as applicable decisions of this Court and the nature of the Regulations. Although the Court of Appeals acknowledges the "liberal federal policy favoring arbitration," Opinion at 3a, using words, by the way, identical to those used in *Moses H. Cone Memorial Hospital*, 460 U.S. at 24, its holding is squarely predicated upon the impermissibility of a direct conflict with the "equal footing" policy of the FAA. See *Byrd*, 470 U.S. at 219.

Moreover, petitioners are wrong in suggesting that the Court of Appeals misconstrued the FAA, as interpreted by this Court. Contrary to petitioners' suggestion, Congress intended to encourage use of arbitration and recognized the "benefit of the legislation for expedited resolution of disputes." *Byrd*, 470 U.S. at 220, 221. Indeed, this Court frequently has reiterated the "emphatic federal policy in favor of arbitral dispute resolution." *Mitsubishi Motors*, 473 U.S. at 631. The result below is fully consistent with this Court's "current strong endorsement of the federal statutes favoring" arbitration. *Rodriguez de Quijas*, 109 S. Ct. at 1920.

Finally, any contention that the Regulations accord with federal policy regarding arbitration overlooks their clear import. The Regulations are not neutral. They regulate "in a manner patently inhospitable to arbitration." Opinion at 5a.

In sum, the Petition fails to demonstrate that the First Circuit decided a federal question in conflict with the applicable decisions of this Court. Further review is not warranted.

II. PETITIONERS HAVE NOT SHOWN AN IMPORTANT QUESTION OF FEDERAL LAW THAT HAS NOT BEEN, BUT SHOULD BE, SETTLED BY THIS COURT.

This case does not present an issue of unsettled federal law. See discussion at Section I. B, *supra*. Even if it did, review by this Court would not be warranted because there is no “important question” which “should be settled by the Court” as those phrases are used in Sup. Ct. R. 17.1(c).

Petitioners point to “[t]he intense interest of state regulators” and “the actions of federal agencies which have addressed mandatory arbitration clauses” to argue that “a question of national significance” is presented. Petition at 13, 14 and 17. The importance of a given subject matter to policy-makers is not the standard under Sup. Ct. R. 17.1(c) for defining what is an “important question of federal law” or determining when such an issue should be decided. Petitioners have not shown, for example, that the Court of Appeals departed from long-established precedent or policy under the FAA. *Cf. Morton v. Ruiz*, 415 U.S. 199, 201-02 (1974); *Patterson v. Lamb*, 329 U.S. 539, 541 (1947). Nor can it be said that a large number of other pending cases hinge on the resolution of this case. *Cf. Laing v. United States*, 423 U.S. 161, 167 (1976). Given the extensive attention this Court already has accorded in recent years to the construction of the FAA, there is no reason, at this time, for yet another foray into the field.

III. THERE IS NO CONFLICT AMONG THE CIRCUITS OR BETWEEN THE FIRST CIRCUIT AND A STATE COURT OF LAST RESORT.

The decision of the First Circuit does not conflict with decisions of other circuit courts or state courts of last resort.

Indeed, it is in harmony with opinions from other circuits. For example, in *Collins Radio Co. v. Ex-Cell-O-Corp.*, 467 F.2d 995, 997 (8th Cir. 1972), the Eighth Circuit held that state law contract formation rules specific to arbitration agreements, such as those at issue here, are preempted. *Collins Radio* struck down a rule requiring that an attorney's acknowledgement accompany an arbitration agreement. More recently, the Eighth Circuit in *Webb v. R. Rowland & Co.*, 800 F.2d 803, 806 (8th Cir. 1986), rejected a state law which purported to render non-enforceable arbitration agreements in "contracts of adhesion," and to require that arbitration agreements be set off in 10-point type. The Tenth Circuit has stressed that, under *Perry*, "arbitration agreements should not be construed by the courts in a manner different from nonarbitration agreements." *Wilson Elec. Contractors, Inc. v. Minnotte Contracting Corp.*, 878 F.2d 167, 169 n.2 (10th Cir. 1989).

The only arguably inconsistent case cited is a decision of the United States District Court for the Eastern District of Virginia. See Petition at 30-31, citing *Saturn Distribution Corp. v. Williams*, 717 F. Supp. 1147 (E.D. Va. 1989). But even a direct and intolerable conflict between a Circuit Court decision and a District Court ruling from another circuit does not warrant certiorari. See Sup. Ct. R. 17.1(a).

Rather than relying on the actuality of inconsistent cases, petitioners advocate that this Court radically alter its standard and accept cases because there is the possibility of "inconsistent cases in the lower courts." Petition at 24. Petitioners point to the existence of other, allegedly similar statutes governing "mandatory arbitration clauses" in the banking and health care context. Petition at 28-30.¹³ Of course, these state laws ulti-

¹³ Alaska Stat. § 0.955.535(b) (Michie 1988 ed.); Cal. Civ. Proc. Code §§ 1295(a) and (b) (West 1982 ed.); Ill. Rev. Stat. c.10, § 209 (West 1987 ed.); Mich. Comp. Laws § 600.5041 (West 1987 ed.); Ohio Rev. Code Ann. § 2711.23 (Banks-Baldwin 1989 Supp.); and S.D. Codified Laws Ann. § 21-25B-3 (Michie

mately may be construed not to reach contracts implicating interstate commerce. Moreover, courts faced with deciding the constitutionality of these laws may reach results consistent with the First Circuit Court of Appeals. Petitioners fail to demonstrate any special reasons why this Court should alter the guidelines for certiorari established in Rule 17.1(a).

IV. THERE IS NO GENUINE DISPUTE AS TO APPLICABLE STATE LAW.

Petitioners complain that the Court of Appeals incorrectly decided a matter of state law, namely, whether "the regulations apply conditions to the formation of arbitration agreements that are common to, if not the rule of, Massachusetts consumer contracts generally. . . ." Petition at 46. Petitioners claim that the Court of Appeals' "application of [the] Act's 'equal footing' objective [to Massachusetts law] is irrational . . ." Petition at 47. *Cf.* Opinion at 36a-38a ("unconscionability is the standard for voluntariness in Massachusetts.")

Petitioners' argument is specious. It is beyond dispute that Massachusetts does not require "bargaining" over all contract terms. Petition at 48. Nor does Massachusetts require "bargaining" over all terms in consumer contracts. Indeed, petitioners do not identify — and did not identify below — any term, other than arbitration, that Massachusetts requires to be "negotiated" in any type of contract.¹⁴

1987 ed.). Petitioners point to no decisions from state courts of last resort construing the laws cited, much less "inconsistent decisions in the lower courts."

¹⁴ Even if state law were unclear — which it is not — certiorari would be inappropriate to resolve an issue of Massachusetts law. *See Bowen v. Massachusetts*, 108 S. Ct. 2722, 2739 (1988); *Brockett v. Spokane Arcades, Inc.*, 472 U.S. 491, 500 (1985).

V. CONCLUSION

For each of the foregoing reasons, respondents respectfully request that the petition for a writ of certiorari be denied.

Respectfully submitted,

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Dated: December 26, 1989

Appendix A**STATEMENT REQUIRED BY RULE 28.1****1. *Securities Industry Association***

The Securities Industry Association has no parent companies, subsidiaries, or affiliates.

2. *Dean Witter Reynolds Inc.*

Sears Roebuck and Co.
Dean Witter Financial Services Group Inc.
Dean Witter Financial Services Inc.
Allstate Insurance Co.
Coldwell Banker Inc.

3. *Donaldson, Lufkin & Jenrette Securities Corporation*

The Equitable Life Assurance Society of the United States
Equitable Investment Corporation
Donaldson, Lufkin & Jenrette, Inc.
Alliance Capital Management L.P.

4. *Drexel Burnham Lambert Incorporated*

The Drexel Burnham Lambert Group Inc.

5. *Fidelity Brokerage Services, Inc.*

FMR Corp.

6. *Kidder Peabody & Co. Incorporated*

General Electric Co.
General Electric Financial Services

7. *Merrill Lynch, Pierce, Fenner & Smith Incorporated*

Merrill Lynch & Co., Inc.

8. *PaineWebber Incorporated*

Paine Webber Group Inc.

9. *Prudential-Bache Securities Inc.*

The Prudential Insurance Company of America
PRUCO, Inc.
Prudential Capital and Investment Services, Inc.
Prudential Securities Group Inc.

10. *Shearson Lehman Hutton Inc.*

American Express Company
Shearson Lehman Hutton Holdings Inc.
First Capital Holdings Corp.

11. *Smith Barney, Harris Upham & Co. Incorporated*

Primerica Corporation
Primerica Holdings, Inc.
Smith Barney Holdings, Inc.
Smith Barney Inc.

(5)
No. 89-894

Supreme Court, U.S.

FILED

MAY 8 1990

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CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1989

MICHAEL J. CONNOLLY, SECRETARY OF STATE
OF MASSACHUSETTS, ET AL., PETITIONERS

v.

SECURITIES INDUSTRY ASSOCIATION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether Section 2 of the Federal Arbitration Act, 9 U.S.C. 2, which provides that an arbitration agreement in "a contract evidencing a transaction involving commerce * * * shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract," precludes the Commonwealth of Massachusetts from adopting regulations concerned exclusively with arbitration provisions in contracts used to open securities brokerage accounts.



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BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is submitted in response to the Court's order inviting the Solicitor General to express the views of the United States.

STATEMENT

1. Congress enacted the Federal Arbitration Act, 9 U.S.C. 1 *et seq.*, in order to "revers[e] centuries of judicial hostility to arbitration agreements" and to "place arbitration agreements 'upon the same footing as other contracts.'" *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 510-511 (1974) (quoting H.R. Rep. No. 96, 68th Cong., 1st Sess. 1, 1 (1924)). In order to accomplish that overarching purpose, the Act provides in Section 2 that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. 2. "In enacting § 2 of the federal Act," this Court has observed, "Congress declared a national policy favoring arbitration and withdrew the power of the states to require

a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration." *Southland Corp. v. Keating*, 465 U.S. 1, 10 (1984). In other words, "Congress intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements." *Id.* at 16 (footnote omitted).

In order to promote the "federal policy favoring arbitration," *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983), the Federal Arbitration Act also provides that a court must stay its proceedings if it is satisfied that an issue before it is subject to an arbitration agreement under the Act, 9 U.S.C. 3. Moreover, the Act authorizes a federal district court to issue an order compelling arbitration if there has been a "failure, neglect, or refusal" to comply with such an agreement, 9 U.S.C. 4. See *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 226 (1987).

2. In *Shearson/American Express Inc. v. McMahon*, *supra*, this Court held that agreements to arbitrate claims against brokerage firms under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), were "enforce[able] . . . in accord with the explicit provisions of the Arbitration Act," 482 U.S. at 238 (quoting *Scherk v. Alberto-Culver Co.*, 417 U.S. at 520).¹ In that decision's wake, the Secretary of State of the Commonwealth of Massachusetts took steps to regulate securities broker-

¹ Before *Shearson/American Express Inc. v. McMahon*, *supra*, it was unclear whether agreements to arbitrate claims under either the Securities Exchange Act of 1934 or the Securities Act of 1933 were enforceable in light of *Wilko v. Swan*, 346 U.S. 427 (1953). See *Shearson/American Express Inc. v. McMahon*, 482 U.S. at 225 n.1. In *Wilko v. Swan*, *supra*, the Court had held that a pre-dispute agreement could not be enforced to compel arbitration of a claim arising under Section 12(2) of the Securities Act of 1933, 15 U.S.C. 77l(2).

The *McMahon* decision called into question the continued vitality of *Wilko v. Swan*. In *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 109 S. Ct. 1917, 1922 (1989), the Court overruled *Wilko v. Swan*, holding that pre-dispute agreements to arbitrate claims against brokerage firms under the Securities Act of 1933 are enforceable under the Federal Arbitration Act.

dealers' use of pre-dispute arbitration provisions in contracts opening brokerage accounts.² Under Massachusetts law, broker-dealers must be registered with the Commonwealth in order to transact securities business. Mass. Gen. L. ch. 110A, § 201 (1985). The Secretary may "deny, suspend, or revoke" that registration upon finding that a broker-dealer "has engaged in dishonest or unethical practices in the securities business." Mass. Gen. L. ch. 110A, § 204(a)(G) (1985).

On September 21, 1988, after public hearing and comment, the Secretary amended the definition of proscribed "dishonest or unethical practices in the securities business" to take account of securities broker-dealers' use of pre-dispute arbitration provisions in contracts opening brokerage accounts. The Secretary declared that the purpose of the amended regulations was to "provide the customer with a meaningful choice prior to making a decision to sign the [arbitration] agreement." Mass. Reg. No. 593 (Oct. 14, 1988).

The amended regulations prohibited broker-dealers from engaging in the following practices as of January 1, 1989: (1) *requiring* customers (other than institutional investors or financial institutions) to "execute either a mandatory pre-dispute arbitration contract or a customer agreement containing a mandatory pre-dispute arbitration clause that is a non-negotiable precondition" to opening or transacting business in a securities account, Mass. Regs. Code tit. 950, § 12.204(G)(1)(a) (1988); (2) *requesting* any customer to enter into such pre-dispute arbitration contracts or agreements without first "conspicuously disclos[ing] that the execution of the contract or agreement cannot be made a non-negotiable precondition" to opening or transacting business in a securities

² Under Massachusetts law, the Commonwealth's Secretary of State regulates securities matters under the Uniform Securities Act, Mass. Gen. L. ch. 110A, §§ 101 *et seq.* (1985 & Supp. 1990). See Mass. Gen. L. ch. 110A, § 406(a) (1985). The Secretary has delegated his regulatory authority to the Director of the Massachusetts Securities Division. See Pet. App. 6a, 61a-62a.

account, Mass. Regs. Code tit. 950, § 12.204(G)(1)(b) (1988); and (3) *requesting* any customer to enter into such pre-dispute arbitration contracts or agreements “without fully disclosing to the customer in writing the legal effect of the pre-dispute arbitration contract or clause,” Mass. Regs. Code tit. 950, § 12.204(G)(1)(c) (1988).³

The amended regulations declared that those prohibited practices “constitute dishonest or unethical practices which are grounds for denial, suspension or revocation of registration or such other action authorized by law.” Mass. Regs. Code tit. 950, § 12.204(G)(1) (1988); see Mass. Gen. L. ch. 110A, § 204(a)(G) (1985). In addition, Massachusetts law provides that

[n]o person who has made or engaged in the performance of any contract in violation of any provision of [the Uniform Securities Act, Mass. Gen. L. ch. 110A, §§ 101 *et seq.* (1985 & Supp. 1990)] or any rule or order hereunder, or who has acquired any purported right under any such contract with knowledge of the facts by reason of which its making or performance was in violation, may base any suit on the contract.

Mass. Gen. L. ch. 110A, § 410(f) (1985).

3. On September 22, 1988, respondents, Securities Industry Association, the trade association for securities dealers, and ten brokerage firms registered to sell securities in Massachusetts, filed an action in the United States District Court for the District of Massachusetts against petitioners, the Commonwealth’s Secretary of State and the Director of the Massachusetts Securities Division. Respondents challenged the validity of petitioners’ arbitration regulations, alleging that Section 2 of the Federal Arbitration Act, 9 U.S.C. 2, which provides that an arbitration agreement “shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or

³ The Secretary promulgated these regulations under his general rulemaking authority. Mass. Gen. L. ch. 110A, § 412 (1985). That state law authority was not challenged in this case.

in equity for the revocation of any contract," preempts those regulations targeted only at pre-dispute arbitration provisions. Respondents sought declaratory and injunctive relief. Pet. App. 56a-58a.⁴

4. On cross-motions for summary judgment, the district court, on December 19, 1988, declared "the Massachusetts securities arbitration regulations * * * violative of the Supremacy Clause * * *, in that they are preempted by the Federal Arbitration Act," Pet. App. 132a, and enjoined petitioners "from enforcing [those] regulations in any manner," *ibid.*

a. The district court found that "[m]andatory written pre-dispute arbitration agreements in some form are used by all [respondents]," Pet. App. 67a, that "these pre-dispute agreements do not purport to advise customers of the 'legal effects' of the arbitration clauses," *ibid.*, and that respondents "are unanimous in asserting a desire to require certain customers to agree to arbitrate disputes as a condition to opening an account," *id.* at 69a.⁵ The

⁴ It was not disputed that the brokerage contracts containing arbitration agreements used by respondent brokerage firms are "contract[s] evidencing a transaction involving commerce" under Section 2 of the Federal Arbitration Act, 9 U.S.C. 2. See 9 U.S.C. 1; Pet. App. 4a, 67a n.6.

Respondents also claimed that the Commonwealth's amended regulations constituted unlawful state action in violation of 42 U.S.C. 1983. See Compl. ¶ 42, *Securities Industry Ass'n v. Connolly*, Civ. No. 88-2153-WD (D. Mass. filed Sept. 22, 1988). Neither the district court nor the court of appeals addressed that claim separately and thus it is not presented here.

⁵ The district court noted that each respondent brokerage firm uses "arbitration agreements in its standard margin and option account contracts, with the exception of Shearson Lehman Hutton Inc., which has no arbitration clause in its option account contract." Pet. App. 68a. The court also found that six of respondent brokerage firms "do not use arbitration accounts in standard cash accounts for individuals, although one [of those firms.] Donaldson Lufkin & Jenrette Securities Corporation, does have an arbitration agreement for corporate customers." *Ibid.* And citing a recent study by the Division of Market Regulation of the Securities and Exchange Commission, the court observed that respondents' "present practice [with respect to pre-dispute arbitration agreements] appears to be

court also found that “any broker who wishes to do business in Massachusetts must observe the securities arbitration contract regulations,” *id.* at 65a, since petitioners had authority to revoke the registration of any firm which engaged in the proscribed “dishonest or unethical practices,” *ibid.* (citing Mass. Gen. L. ch. 110A, § 204 (1985)). Moreover, the court found that

if a broker—or for that matter a customer—were to attempt to enforce a contract formed without compliance with the Massachusetts securities arbitration regulations, that attempt would be unavailing.

Pet. App. 66a (citing Mass. Gen. L. ch. 110A, § 410(f) (1985); see p. 4, *supra*). Accordingly, the court determined that those regulations “will have an immediate effect on the contracts used by broker-dealers transacting business with customers located in Massachusetts * * * by establishing additional disclosure requirements [and] prevent[ing] broker-dealers from implementing the apparently universal practice of requiring at least certain customers to enter into arbitration agreements for their disputes.” Pet. App. 66a, 70a.

b. Turning to respondents’ preemption claim under the Federal Arbitration Act, the district court “focus[ed] on whether the state regulations single out arbitration agreements for special treatment.” Pet. App. 76a (internal quotation marks omitted). The court noted that “the fundamental purpose of the Federal Arbitration Act was to place an arbitration agreement upon the same footing as other contracts, where it belongs,” *id.* at 76a-77a (internal quotation marks omitted), and that that congressional mandate was “expressly embodied in [Section 2 of the Act],” *id.* at 78a. Accordingly, Section 2 of the Act “preempts state statutory and case law that treats arbitration agreements differently from any other contract.” *Ibid.* (quoting *Cook Chocolate Co. v. Salomon, Inc.*, 684 F. Supp. 1177, 1182 (S.D.N.Y. 1988)).

fairly representative of the brokerage business generally.” *Id.* at 69a n.7.

Petitioners conceded that the challenged regulations “single out arbitration agreements,” Pet. App. 79a, but sought to avoid preemption on the ground that those regulations furthered another purpose of the Federal Arbitration Act—“the concern to implement voluntary agreements to arbitrate,” *id.* at 80a. The district court rejected that contention as a “semantic sleight of hand.” *Id.* at 81a. As the court explained:

[T]he concept of voluntariness addresses the fundamental principles of contract formation upon which questions of validity, revocability, and enforceability of arbitration agreements turn. As used in that way, the concept of voluntariness is not a matter subject to idiosyncratic rules or definitions. [Petitioners are] not free under the Federal Arbitration Act to develop a definition of voluntariness applicable only to the negotiation of arbitration agreements and not to other contracts generally.

That, of course, is precisely what [petitioners’] purported voluntariness enhancements do.

Id. at 81a-84a (footnote omitted).⁶ The court therefore held that “[b]ecause the voluntariness concerns expressed in [the challenged regulations] impose conditions on the formation and execution of arbitration agreements which are not part of the generally applicable contract law of Massachusetts, [those regulations] cannot be given effect under the Federal Arbitration Act.” *Id.* at 89a.⁷

⁶ The district court noted that “[t]here is no general contractual duty in Massachusetts requiring one party to describe fully—or for that matter, at all—the legal effect of a contractual provision to another party with whom the first party proposes to contract.” Pet. App. 84a. The court also found that Massachusetts law does not impose “any general restriction requiring specific provisions to be ‘negotiable.’” *Id.* at 85a.

⁷ Petitioners also contended that “savings clauses” in federal securities statutes (15 U.S.C. 77r; 15 U.S.C. 78bb(a); 15 U.S.C. 80b-18a), which provide for complementary state regulation in the securities markets, show Congress’s intention to permit otherwise complementary state regulation of securities arbitration provisions. The district court rejected that argument, Pet. App. 97a-98a, as did

c. Finally, the district court concluded that if its entry of summary judgment were vacated as premature, respondents were nevertheless entitled to preliminary injunctive relief. Pet. App. 106a-126a.*

5. On August 31, 1989, the court of appeals unanimously affirmed. Pet. App. 1a-52a. The court acknowledged that "a state law or regulation cannot take root if it looms as an obstacle to achievement of the full purposes and ends which Congress has itself set out to accomplish." *Id.* at 12a (citing cases). After reviewing this Court's recent decisions construing the Federal Arbitration Act, the court of appeals noted that "their common denominator is a principle of rigorous equality under 9 U.S.C. § 2." *Id.* at 20a. Accordingly, by virtue of Section 2 of the Federal Arbitration Act, "no state may simply subject arbitration to individuated regulation in the same manner as it might subject some other unprotected contractual device (say, a prescriptive period or exculpatory clause contained within a private contract)." *Id.* at 21a.

Petitioners conceded that the challenged regulations apply only to arbitration agreements, but claimed that those regulations were a needed means of consumer protection and thus fell outside the proscription of Section 2

the court of appeals, *id.* at 30a-31a. Petitioners have abandoned that argument in this Court.

* Petitioners had filed a motion under Fed. R. Civ. P. 56(f), requesting the district court to delay its decision pending further discovery. The district court denied that motion. Pet. App. 99a-106a. As the court explained:

The material consequences are plain here. * * * Massachusetts could not have been clearer in its intention—despite its oblique means of execution—to make securities arbitration contracts subject to different rules regarding validity and enforceability from those that govern other contracts. It takes no further factual development to reach that conclusion.

Id. at 103a-104a. Petitioners renewed that claim on appeal, but the court of appeals declined to resolve it, concluding that "the Rule 56(f) motion is * * * beside the point." *Id.* at 48a n.10. Petitioners have not sought further review of that aspect of the court of appeals' judgment.

of the Federal Arbitration Act. Pet. App. 23a-24a.⁹ The court of appeals dismissed that contention, explaining that “[i]n creating a body of substantive law co[.]vering arbitration, Congress barred the states from making determinations about arbitration contracts that the states remained free to make about, say, used car sales.” *Id.* at 24a (citing *Perry v. Thomas*, 482 U.S. 483, 492 n.9 (1987)). In other words, the Federal Arbitration Act “prohibits a state from taking more stringent action addressed specifically, and limited, to arbitration contracts.” Pet. App. 25a.¹⁰

The court of appeals acknowledged recent rules regarding pre-dispute arbitration provisions adopted by the Commodity Futures Trading Commission and the Securities and Exchange Commission that were similar to petitioners’ regulations. Pet. App. 32a-33a; see pp. 18-19, *infra*. But the court pointed out the “critical distinction” that those provisions “are products of federal, not state, authority.” *Id.* at 33a (citing *Shearson/American Express Inc. v. McMahon*, 482 U.S. at 226). The court therefore concluded that petitioners erred in relying on those federal regulatory efforts, since “Congress has not

⁹ The court of appeals noted that neither petitioners nor respondents “suggested * * * that any of the provisions [of the regulations] might be severable.” Pet. App. 3a-4a. Accordingly, the court “treat[ed] them as a unit for purposes of * * * preemption analysis.” *Id.* at 4a. Petitioners have maintained the same position in this Court.

¹⁰ The court of appeals pointed out that petitioners were not powerless to remedy “a perceived problem” with respect to securities arbitration agreements. Pet. App. 25a. To the contrary, petitioners’ “powers remain great, so long as used evenhandedly.” *Ibid.* The court of appeals referred (*id.* at 26a) to *Perry v. Thomas*, 482 U.S. 483 (1987), where the Court determined that “state law * * * is applicable *if* that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally,” *id.* at 493 n.9 (emphasis in original). Moreover, the court suggested that petitioners could “pass legislation declaring all contracts of adhesion presumptively unenforceable. * * * Such a rule would apply to arbitration contracts, *among others*.” Pet. App. 26a-27a (emphasis in original).

structured a similar arbitration exception for securities in general and certainly not for state regulation of securities in particular." Pet. App. 33a.

Lastly, the court of appeals rejected petitioners' argument that, since broker-dealers remained free to use pre-dispute arbitration agreements (and those agreements would be enforceable under state law), so long as broker-dealers complied with the arbitration regulations, those regulations did not contravene the Federal Arbitration Act. The court of appeals found that the regulations,

by requiring what is not generally required to enter contracts in the Commonwealth, *e.g.*, certain negotiations, explanations, and disclosures, inhibit a party's willingness to create an arbitration contract or undermine the contract's enforceability (if the party proceeds notwithstanding the edict).

Pet. App. 38a.¹¹ As the Court stated in *Perry v. Thomas*, 482 U.S. at 493 n.9, "[a] state-law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue does not comport with [the equality] requirement of § 2." The court of appeals therefore heeded Congress's direction in Section 2 to "foreclose state legislative attempts to undercut the enforceability of arbitration agreements." Pet. App. 41a (quoting *Southland Corp. v. Keating*, 465 U.S. at 16). Moreover, the court concluded that a firm's "worry that requiring a [pre-dispute arbitration agreement] might forfeit [its] ability to function as a broker-dealer at all is [also] an obstacle" to fulfilling "the federal policy to 'favor[] arbitration agreements.'" Pet. App. 43a (quoting *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983)).

DISCUSSION

This case involves the legal question whether Section 2 of the Federal Arbitration Act, 9 U.S.C. 2, precludes

¹¹ Despite that express finding, in another portion of its opinion the court of appeals noted, but "express[ed] no opinion" on, Pet. App. 37a, the district court's finding that an arbitration agreement made in violation of the regulations would be unenforceable under state law. See *id.* at 66a; p. 6, *supra*.

state regulation of securities arbitration agreements to the extent those regulatory efforts subject such agreements to treatment not generally accorded other similar contractual provisions under applicable state law.¹² Although it has not squarely decided that issue, the Court has consistently drawn the distinction between impermissible state arbitration regulations that single out and subject arbitration provisions to a different enforcement regime under state law, and permissible state regulations of general application that necessarily encompass arbitration provisions in contracts. The Federal Arbitration Act bars the former regulatory efforts precisely because such state action violates the anti-discrimination principle embodied in Section 2 of the Act.

Here, the court of appeals applied the distinction drawn by this Court to hold that Section 2 preempts petitioners' securities arbitration regulations, where petitioners conceded (see, e.g., Pet. App. 23a-24a, 79a) that such regulations subjected arbitration provisions to special treatment under state law. That decision is consistent with the Court's case law construing the Federal Arbitration Act and does not conflict with any other court of appeals' decision. In light of these factors, and in the absence of any indication that the decision will effectively undermine state and federal regulatory efforts to police securities arbitration provisions, we believe that further review is unwarranted.

A. 1. Under the Supremacy Clause, U.S. Const. Art. VI, Cl. 2, Congress may preempt state law in several ways. See, e.g., *Fidelity Fed. Sav. & Loan Ass'n v. De la Cuesta*, 458 U.S. 141, 152-153 (1982). Preemption cases often present difficult questions concerning congressional intent and whether state law intrudes on a field

¹² Petitioners discuss at length the asserted laudable policies underlying their securities arbitration regulations and point out that federal regulatory authorities appear to share that viewpoint. See, e.g., Pet. 13-32, 38-40, 48-49. This case, however, raises the legal issue of whether the Federal Arbitration Act precludes petitioners' regulations, not whether those regulations are based on sound public policy. See pp. 18-19, *infra*.

occupied by Congress, inhibits accomplishment of federal purposes, or actually conflicts with federal law. This case does not. Here, Congress has provided that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. 2. The state regulations at issue purport to prohibit the formation of arbitration agreements on grounds that are applicable only to such agreements, not to "any contract." While the parties and lower courts have viewed the issue presented as one of preemption—and while that does provide a useful analytic framework—the case may be more starkly viewed as one in which the state regulations simply violate federal law. In this case it is not so much that the state has attempted to regulate a subject matter in a way that intrudes upon or conflicts with federal regulation of the same matter; rather, the state has attempted to do precisely that which federal law says it may *not* do—treat arbitration agreements differently than other contracts. This is thus a preemption case, but only in the sense that every Supremacy Clause case is a preemption case.

Section 2 of the Federal Arbitration Act "embodies a clear federal policy of requiring arbitration unless the agreement to arbitrate is not part of a contract evidencing interstate commerce or is revocable 'upon such grounds as exist at law or in equity for the revocation of any contract.'" *Perry v. Thomas*, 482 U.S. at 489 (quoting 9 U.S.C. 2). "In enacting § 2 of the federal Act," the Court has observed, "Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration." *Southland Corp. v. Keating*, 465 U.S. at 10. "Congress intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements." *Id.* at 16. Moreover, the Court has "see[n] nothing in the Act indicating that the broad principle of enforceability is subject to any additional

limitations under state law." *Id.* at 11; see *Perry v. Thomas*, 482 U.S. at 489-490.

The anti-discrimination policy embodied in the succinct language of Section 2 stems from the principal reason Congress enacted the Federal Arbitration Act—to "revers[e] centuries of judicial hostility to arbitration agreements." *Scherk v. Alberto-Culver Co.*, 417 U.S. at 510. As the House Report explained:

The need for the law arises from an anachronism of our American law. Some centuries ago, because of the jealousy of the English courts for their own jurisdiction, they refused to enforce specific agreements to arbitrate upon the ground that the courts were thereby ousted from their jurisdiction. This jealousy survived for so lon[g] a period that the principle became firmly embedded in the English common law and was adopted with it by the American courts.

H.R. Rep. No. 96, *supra*, at 1-2. The Act therefore "place[s] arbitration agreements 'upon the same footing as other contracts.'" *Scherk v. Alberto-Culver Co.*, 417 U.S. at 511 (quoting H.R. Rep. No. 96, *supra*, at 1); see, e.g., *Volt Information Sciences, Inc. v. Board of Trustees*, 109 S. Ct. 1248, 1253 (1989). In other words, the anti-discrimination principle of Section 2 reflects Congress's considered judgment, given the historical antipathy of courts and state legislatures to arbitration, that differential state law treatment of arbitration provisions would undermine the "declared * * * national policy favoring arbitration." *Southland Corp. v. Keating*, 465 U.S. at 10.

2. Accordingly, in both *Southland Corp. v. Keating*, 465 U.S. at 16, and *Perry v. Thomas*, 482 U.S. at 491-493, the Court held that Section 2 preempted state law provisions which singled out certain arbitration agreements as unenforceable. As the Court explained in *Perry v. Thomas*:

[S]tate law, whether of legislative or judicial origin, is applicable *if* that law arose to govern issues concerning the validity, revocability, and enforceability

of contracts generally. A state-law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue does not comport with [Section 2 and is preempted].

482 U.S. at 493 n.9 (emphasis in original). If Section 2 were construed otherwise, the Court has recognized, "states could wholly eviscerate congressional intent to place arbitration agreements 'upon the same footing as other contracts,' * * * simply by passing statutes [excepting certain arbitration agreements from the state law of contract]." *Southland Corp. v. Keating*, 465 U.S. at 17 n.11.

B. 1. Despite the principles described above, petitioners contend (Pet. 32-49) that the court of appeals erred in holding that the Federal Arbitration Act preempts securities arbitration regulations "that simply require disclosure and bargaining in the formation of arbitration agreements in a regulated industry," Pet. 35, where, as here, "they do not limit the ability of parties to enter into arbitration agreements, nor limit the enforcement of arbitration agreements once entered," Pet. 36. Petitioners thus seek to distinguish this case from *Perry* and *Keating*, and also take it outside the purview of the anti-discrimination principle of Section 2 of the Federal Arbitration Act, on the ground that the securities arbitration regulations do not foreclose broker-dealers from seeking (and customers from agreeing to) mandatory and enforceable pre-dispute arbitration agreements, so long as the prerequisites of the state regulations are met.

None of this Court's decisions construing the Federal Arbitration Act has specifically considered the distinction petitioners seek to draw.¹³ Nevertheless, the Court

¹³ Petitioners err in relying (Pet. 41-42) on *Volt Information Sciences, Inc. v. Board of Trustees*, *supra*. In *Volt*, the Court held that the Federal Arbitration Act does not preempt application of a state law arbitration provision where the parties agreed that their arbitration agreement will be governed by that state law. As the Court explained, "[w]here, as here, the parties have agreed to abide by state rules of arbitration, enforcing those rules according to the terms of the agreement is fully consistent with the goals of

has consistently determined that Section 2 of the Act preempts state law to the extent it singles out and subjects arbitration—as opposed to other contractual—provisions to a different enforcement regime under state law. See, e.g., *Perry v. Thomas*, 482 U.S. at 491-493; *Southland Corp. v. Keating*, 465 U.S. at 16. Indeed, the Court has made plain that

[a]bsent a well-founded claim that an arbitration agreement resulted from the sort of fraud or excessive economic power that would provide grounds for the revocation of any contract, * * * the Arbitration Act provides no basis for disfavoring agreements to arbitrate statutory claims by skewing the otherwise hospitable inquiry into arbitrability.

Shearson/American Express Inc. v. McMahon, 482 U.S. at 226 (internal quotation marks omitted).

Here, the challenged securities arbitration regulations plainly single out and subject arbitration provisions to treatment not accorded other contractual provisions under state law. Indeed, petitioners conceded as much. See, e.g., Pet. 23a-24a, 79a.¹⁴ And the record confirms that those

the [Federal Arbitration Act], even if the result is that arbitration is stayed where the Act would otherwise permit it to go forward.” 109 S. Ct. at 1255. In *Volt*, the Court had no occasion to consider the preemptive force of Section 2, since the California law incorporated by the parties’ choice-of-law provision did not purport to render the arbitration agreement unenforceable under state law. Here, by contrast, the record confirms that the challenged regulations would render mandatory pre-dispute arbitration agreements unenforceable under Massachusetts law, absent compliance with those regulatory provisions. See Pet. App. 38a, 66a; pp. 6, 10, *supra*.

¹⁴ In passing, petitioners assert—without citation to any state law authority—that “the regulations apply conditions to the formation of securities arbitration agreements that are common to, if not the rule of, Massachusetts consumer contracts generally and securities transactions in particular.” Pet. 46. That sort of vague and unsupported assertion scarcely calls into question the documented finding of the district court that “[t]here is no general contractual duty in Massachusetts requiring one party to describe fully—or for that matter, at all—the legal effect of a contractual provision to another party with whom the first party proposes to contract.” Pet.

state regulations—applicable only to securities arbitration provisions—would undermine enforcement under state law of otherwise voluntary mandatory pre-dispute arbitration agreements. See Pet. App. 38a, 66a; pp. 6, 10, *supra*. The decision of the court of appeals therefore comports with the general principles enunciated in this Court's decisions construing the effect of Section 2 of the Federal Arbitration Act.

2. Moreover, the court of appeals' application of Section 2 to invalidate state regulations subjecting arbitration provisions to a different enforcement regime under state law, and consequent rejection of the distinction drawn by petitioners, does not conflict with any other court of appeals decision. To the contrary, the decision below is consistent with those decisions that have considered analogous challenges under Section 2 to state laws aimed at arbitration provisions. In *Collins Radio Co. v. Ex-Cell-O Corp.*, 467 F.2d 995 (8th Cir. 1972), for example, the court of appeals refused to invalidate an arbitration clause on the ground that it was unenforceable under Texas law, which required arbitration agreements to be "concluded upon the advice of counsel to both parties as evidenced by counsels' signatures," Tex. Rev. Civ. Stat. Ann. art. 224 (Vernon Supp. 1972). The court of appeals reasoned that Section 2 of the Federal Arbitration Act

plainly voids all doctrines of invalidity, unenforceability and revocability which apply only to arbitration agreements. The plain meaning of § 2 is that federal courts are no longer to apply state statutes and decisions which limit arbitration agreements with rules not applicable to other contracts.

467 F.2d at 998 (citing cases).

App. 84a; accord *id.* at 38a (concurrent finding of court of appeals). Nor does petitioners' assertion call into question the district court's observation that Massachusetts law does not impose "any general restriction requiring specific provisions to be 'negotiable.'" *Id.* at 85a (citing *Zapatha v. Dairy Mart, Inc.*, 381 Mass. 284, 408 N.E. 2d 1370 (1980)); accord Pet. App. 38a (court of appeals' opinion).

Similarly, in *Medical Dev. Corp. v. Industrial Molding Corp.*, 479 F.2d 345, 348 (10th Cir. 1973), the court of appeals rejected a contracting party's request to hold that an arbitration provision was not part of the contract on the basis of California state law "rules applicable to arbitration agreements." The court concluded that, under Section 2 of the Federal Arbitration Act, "federal courts do not apply state statutes and decisions which limit arbitration agreements with rules not applicable to other contracts." *Ibid.*; see, e.g., *Webb v. R. Rowland & Co.*, 800 F.2d 803, 806-807 (8th Cir. 1986) (court refuses to apply a Missouri law that requires all arbitration provisions to be accompanied by a notice, in ten point capital letters, that the contract contains such a provision); *Cook Chocolate Co. v. Salomon, Inc.*, 684 F. Supp. 1177, 1182 (S.D.N.Y. 1988) (citing *Perry v. Thomas*, *supra*, court refuses to apply New York case law that "applies the incorporation doctrine more strictly to arbitration agreements than nonarbitration agreements and requires a specific reference to arbitration within the body of the principal agreement").

Petitioners' amici (Br. 3-5) contend that the court of appeals' decision conflicts with *Supak & Sons Mfg. Co. v. Pervel Indus., Inc.*, 593 F.2d 135 (4th Cir. 1979). There, the Fourth Circuit held that an arbitration provision in a written confirmation materially altered the previous oral contract between the parties and thus did not become part of the contract under U.C.C. § 2-207 (1976). The court of appeals specifically noted that Section 2-207 "is * * * a general rule of contract formation" that applies broadly to all terms that materially affect the parties' expectations. 593 F.2d at 137. Here, by contrast, it is undisputed that the securities arbitration regulations, by definition, apply only to arbitration provisions. For that reason, the decision below is consistent with *Supak*.

In any event, the Fourth Circuit in *Supak* suggested that the Federal Arbitration Act "would preempt a state rule of contract formation which applied only to arbitration clauses and which placed an unreasonable burden on the parties' ability to commit themselves to arbitration."

593 F.2d at 137.¹⁵ Of course, petitioners' regulations, which, among other things, effectively inhibit broker-dealers from requiring customers to execute mandatory pre-dispute arbitration agreements, impose precisely that sort of impermissible burden. See, *e.g.*, Pet. App. 43a. Since there is no conflict among the courts of appeals on the preemption issue presented, further review is not warranted.

C. Finally, contrary to claims raised by petitioners (Pet. 13-32) and their amici (Br. 12-15), the court of appeals' decision will not effectively undermine state and federal regulatory efforts to police securities arbitration provisions. First, the decision will not effect federal regulation in this area. As petitioners point out (Pet. 17-20), both the CFTC and the SEC—the federal agencies responsible for regulating the commodities and securities markets nationwide—have already taken steps to promote

¹⁵ Petitioners contend (Pet. 30-31) that the court of appeals' decision conflicts with *Saturn Distrib. Corp. v. Williams*, 717 F. Supp. 1147 (E.D. Va. 1989), appeal pending, No. 89-2773 (4th Cir.) (argued Dec. 6, 1989). In that case, the district court held that the Federal Arbitration Act did not preempt a Virginia law which prohibited automobile manufacturers from requiring franchise dealers to sign arbitration clauses as a condition of dealership agreements. Va. Code Ann. § 46.1-550.3:27(10) (1988). The court concluded that "[b]y ensuring consensual rather than forced arbitration, the Virginia statute is entirely in harmony with the Federal Arbitration Act." 717 F. Supp. at 1151. The court also distinguished the district court's decision here on the ground that the Virginia statute "does not single out arbitration agreements for special treatment, but rather forms an unexceptional part of the law of Virginia applicable to the formation of contracts." *Id.* at 1152.

To the extent that *Saturn Distrib. Corp.* rests on that distinction, it is not inconsistent with the decision below. On the other hand, to the extent that the purported distinction rests on a faulty premise, see 717 F. Supp. at 1150 ("an overview of the law of Virginia that governs the formation of contracts reveals that [the state law at issue] . . . affords privileged status to arbitration agreements"), *Saturn Distrib. Corp.* cannot be squared with the decision below. Nevertheless, since that case, which was decided before the First Circuit issued its opinion, remains pending before the Fourth Circuit, further review of the present case would be premature.

the efficient and fair use of arbitration provisions. Under its statutory authority to regulate dispute resolution between commodities brokers and customers, see 7 U.S.C. 7a(5), 21(b)(10), the CFTC has adopted regulations concerning the use of pre-dispute arbitration provisions. See 17 C.F.R. 180.3. Those regulations, among other things, forbid brokers from making a customer's executing a pre-dispute arbitration provision a condition for transacting business, see 17 C.F.R. 180.3(b)(1), and require brokers to disclose, in large bold-face type, the customer's rights and legal effect of an arbitration provision, 17 C.F.R. 180.3(b)(6).

Similarly, the SEC, under its statutory authority to regulate self-regulatory organizations in the securities industry, see 15 U.S.C. 78s(b), has recently approved self-regulatory organization rules requiring brokers to disclose and highlight the effects of signing an arbitration clause. Those rules, among other things, also prohibit brokers from using an arbitration clause to limit the relief available in arbitration. See *Self-Regulatory Organizations, Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses*, 54 Fed. Reg. 21,144 (1989).¹⁶

Second, as the court of appeals pointed out, petitioners are not powerless to remedy "a perceived problem" with respect to securities arbitration agreements. Pet. App. 25a. To the contrary, petitioners' "powers remain great, so long as used evenhandedly." *Ibid.* Absent controlling federal law, the state legislature presumably could accomplish the goal of the securities arbitration regula-

¹⁶ Petitioners contend (Pet. 38-39) that the federal regulatory efforts in the arbitration area confirm the sound policies—*i.e.*, consumer protection—underlying the challenged regulations at issue. That contention, however, is beside the point for purposes of resolving the preemption question presented in this case, since the actions of the CFTC and the SEA "are products of federal, not state, authority." Pet. App. 33a.

tions by enacting a state law providing, for example, that forum selection clauses in all consumer contracts must be the subject of negotiation and full disclosure. See also Pet. App. 26a-27a. In other words, application of the anti-discrimination principle of Section 2 of the Federal Arbitration Act is by no means tantamount to outlawing state regulation of arbitration provisions. Federal law simply guarantees that arbitration agreements not be singled out for special treatment. That is precisely what Massachusetts attempted to do here.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

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In The
Supreme Court of the United States
October Term, 1989

MICHAEL J. CONNOLLY,
MASSACHUSETTS SECRETARY OF STATE, *et al.*,
Petitioners,

v.

SECURITIES INDUSTRY ASSOCIATION, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the
United States Court of Appeals for the First Circuit

BRIEF OF ALASKA, ARIZONA, COLORADO, CON-
NECTICUT, HAWAII, IDAHO, IOWA, KANSAS, KEN-
TUCKY, LOUISIANA, MAINE, MARYLAND,
MICHIGAN, MINNESOTA, MONTANA, NEBRASKA,
NEW HAMPSHIRE, NEW MEXICO, NORTH CARO-
LINA, NORTH DAKOTA, OHIO, OKLAHOMA, ORE-
GON, PENNSYLVANIA, SOUTH DAKOTA, TEXAS,
UTAH, VERMONT, VIRGINIA AND WEST VIRGINIA*
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INTEREST OF AMICI CURIAE

The decision of the First Circuit Court of Appeals in *Securities Industry Ass'n v. Connolly*, 883 F.2d 1114 (1st Cir. 1989), invalidates regulations of the Commonwealth of Massachusetts designed to insure that purchasers of securities who sign form brokerage agreements containing arbitration clauses do so knowingly and voluntarily. The challenged regulations accomplish this objective by (1) requiring securities brokers to disclose to customers the legal effects of a mandatory arbitration clause in a brokerage agreement, and (2) prohibiting brokerage firms from imposing arbitration agreements upon customers as a non-negotiable condition precedent to opening brokerage accounts. The First Circuit ruled that these regulations were preempted by the Federal Arbitration Act, 9 U.S.C. §§ 2-9 ("FAA" or "the Act"), because they single out arbitration agreements for more stringent treatment than other contractual provisions.

Connolly extends the sweep of federal preemption of the FAA beyond the intent of Congress and, thereby, frustrates the purposes of the Act. The effect of the ruling is to leave the states powerless to protect consumers from being coerced to enter arbitration agreements. Amici curiae have a legitimate regulatory interest in protecting their citizens from an uninformed waiver of other available options for dispute resolution, particularly in industries where market forces do not insure that consumers have adequate information to make a voluntary waiver.

The effect of *Connolly* extends to other industries where economic realities may, in effect, deny consumers

and small businessmen the option of any means of dispute resolution other than an arbitration process dictated by the offeror on a "take it or leave it" basis. Accordingly, amici submit their brief amici curiae supporting the petition for certiorari.

SUMMARY OF ARGUMENT

Amici urge the Court to grant Massachusetts' petition for a writ of certiorari because the decision in *Connolly* misconstrues both Congressional intent in enacting the FAA and the precedent of this Court. While the Court has consistently ruled that the FAA requires the states to honor arbitration agreements between the parties to a contract, it has never ruled that the FAA renders the states powerless to regulate the process by which such agreements are reached in order to avoid coerced arbitration.

The wording of the FAA does not suggest an intent to preempt state regulation of all aspects of the arbitration process. A review of the legislative history of the FAA clearly indicates that Congress intended that the states retain the power to regulate the process of contract formation to ensure that privately negotiated arbitration is consensual rather than coerced.

If the FAA is construed to prohibit states from requiring that arbitrability be negotiable, citizens could be forced to forego state and federal remedies by being coerced into an arbitration process favoring and solely tailored by the offering party. The purpose of the FAA is to enforce arbitration of contractual disputes between the

parties according to the terms to which they have bound themselves. State regulation designed solely to require that the parties freely and knowingly accept those terms furthers rather than frustrates that purpose.

ARGUMENT

I. CONNOLLY CREATES A CONFLICT AMONG THE CIRCUITS CONCERNING THE EFFECT OF THE FAA UPON STATE LAWS GOVERNING THE PROCESS OF CONTRACT FORMATION

The *Connolly* court apparently was not impressed with the distinction between state regulation of the *process* of contract formation and the *enforcement* of contracts made by consenting parties for purposes of FAA preemption. Instead, the court found the FAA prohibited the states from adopting *any* regulation which singles out arbitration agreements for special treatment not applicable to other contracts generally, observing that such regulation demonstrates hostility towards arbitration contrary to the FAA. That broad interpretation of the FAA conflicts with the decision of the Fourth Circuit Court of Appeals in *Supak & Sons Mfg. Co., Inc. v. Pervel Industries, Inc.*, 593 F.2d 135 (4th Cir. 1979), wherein the court premised its analysis of an FAA challenge to a state law of contract formation with the observation that the FAA "does not displace state law on the general principles governing formation of the contract itself," and "[b]y its terms, § 2

[of the FAA] does not apply until the arbitration in question is determined to be part of the contract." 593 F.2d 137.

Plaintiff in *Supak* sought unsuccessfully to invoke arbitration procedures to resolve a contractual dispute under a sales contract governed by the Uniform Commercial Code. Plaintiff relied upon an oral agreement with defendant to arbitrate disputes; defendant argued that arbitration was not available because state law deemed the addition of arbitrability a "material alteration" of a contract requiring written confirmation by the parties. The court held that the FAA does not preempt the states from limiting arbitrability in this manner, suggesting that state laws governing contract formation would be preempted under the FAA only if they were solely applicable to arbitration *and* placed an "unreasonable burden on the parties' ability to commit themselves to arbitration." *Id.*¹

The question presented by this petition is whether the *Connolly* analysis (*any* specific state regulation of arbitrability is presumptively preempted by the FAA) or that of *Supak* (FAA preempts only state law which either impedes enforcement of arbitration agreements or which unreasonably burdens the parties' ability to consent to

¹ Consistent with *Supak*, a federal district court rejected an FAA preemption challenge to Virginia law requiring that arbitration clauses in motor vehicle franchise contracts be negotiable. *Saturn Distribution Corp. v. Williams*, 717 F.Supp. 1147 (E.D. Va. 1989). That case is currently on appeal to the Fourth Circuit Court of Appeals.

arbitration) is the correct interpretation of the FAA. It is a question which this Court has not yet considered. More importantly, it is vitally significant to the power of states to regulate contractual relationships in order to protect unwary consumers against coerced waivers of judicial or administrative means of dispute resolution.

II. THE FAA NEITHER EXPRESSLY NOR IMPLICITLY PREEMPTS ALL STATE REGULATION OF ARBITRATION

Whether the FAA preempts the states from regulating arbitration clauses in contracts of adhesion is the dispositive legal issue raised by this petition. Any analysis of a claim of federal preemption must begin with the premise that there is a presumption against preemption. "Preemption of state law by federal statute or regulation is not favored 'in the absence of persuasive reasons. . . .'" *Chicago & North Western Transportation Corp. v. Kalo Brick & Tile Co.*, 450 U.S. 311, 317 (1981) [quoting *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142 (1963)].

Whether federal law preempts state regulation is determined by Congressional intent, which may be found by (a) explicit statutory language, (b) implication arising from the fact that the federal law is so pervasive as to occupy the entire field of regulation to the exclusion of supplementary state regulation, or (c) evidence that the challenged state law conflicts with, or stands as an obstacle to, federal law. As the *Connolly* court concedes, there is neither explicit preemption language in the FAA nor any indication that Congress intended to exclude the

states from the field of regulation of arbitration. Accordingly, *Connolly* is based solely upon a determination that a state regulation requiring that an agreement to arbitrate be voluntary conflicts with the intent of FAA. *Connolly* is wrong because it ignores the legislative history of the FAA that clearly indicates that the challenged regulations are consistent with the intent of the drafters of the FAA.

III. THE LEGISLATIVE HISTORY OF THE FAA BELIES THE CONTENTION THAT THE STATES' REGULATION OF ARBITRABILITY IS INCONSISTENT WITH THE FAA

A divided Court in *Southland Corp. v. Keating*, 465 U.S. 1 (1984), ruled that the FAA withdrew the power of the states to require a judicial forum for resolution of contract disputes. Justice Stevens, in dissent, concluded that Congress did not intend to require states to honor arbitration agreements in franchise relationships where the relative disparity in bargaining position between the parties warranted regulatory protection for the weaker party. While Justice Stevens' argument did not persuade the majority, his view, supported by the legislative history of the FAA, that Congress assumed there is a role for state regulation of arbitrability is echoed in this Court's recent decision in *Volt Information Sciences, Inc. v. Board of Trustees*, 109 S.Ct. 1248 (1989).

That legislative history is extensive and consistently supports the validity of the Massachusetts regulations. It suggests that the intent of Congress in enacting the FAA was modest. Rather than having as its purpose the pre-emption of state regulation of arbitration, the FAA was

designed simply to overcome traditional judicial resistance to the enforcement of voluntary arbitration agreements between contracting parties.

The official reports of the two bills, which ultimately were codified as the FAA (H.R. 646 and S. 1005), underscore the limited scope of the legislation. Congressman Graham, who authored the House Report of H.R. 646, summarized the effect of the bill for his colleagues as follows:

Arbitration agreements are purely matters of contract and the effect of the bill is simply to make the contracting party live up to his agreement. He can no longer refuse to perform his contract when it becomes disadvantageous to him.

Report No. 96 on H.R. 646, 68th Cong., 1st Sess.
(Jan. 24, 1924).

The Senate report on its counterpart to H.R. 646, S. 1005, similarly stresses the enforcement of *voluntary* agreements as the impetus behind the new law:

The record made under the supervision of this society [referring to the Arbitration Society of America] shows not only the great value of voluntary arbitrations but the practical justice in the enforced arbitration of disputes where written agreements for that purpose have been voluntarily and solemnly entered into.

Report 536 on S. 1005, 68th Cong., 1st Sess. (May 14, 1924).

While the Act was carefully considered over two sessions of Congress, it passed without substantial opposition. This lack of opposition may be explained by the modest purpose of the Act – to require that parties who

have agreed to arbitrate their disputes honor that agreement.

Fears by members of Congress that the legislation would supplant state law was addressed by its supporters. During the Congressional hearings on the FAA in 1924, one of the chief draftsmen of the legislation, Mr. Julius Cohen, submitted a brief to two Congressional subcommittees stating that the proposed legislation would not supersede state law on contract formation:

It [the FAA] is no infringement upon the right of each State to decide for itself what contracts shall or shall not exist under its laws. To be sure whether or not a contract exists is a question of the substantive law of the jurisdiction wherein the contract was made.

Joint Hearings on S.B. 1005 and H.R. 646 Before the Subcommittees of the Committees on the Judiciary, 68th Cong., 1st Sess. (1924) at 37 (the "1924 Hearings"). There is nothing in the record of those hearings to suggest that the Act would affect the states' power to regulate the process of contract formation.

Moreover, the transcripts of the Congressional hearings reflect that the FAA was not intended to require the states to tolerate coerced arbitration through adhesive contracts. During hearings on the proposed FAA in 1923, Senator Walsh expressed his concern that arbitration clauses often appeared in "take it or leave it" contracts. A proponent and drafter of the FAA, W.H.H. Piatt, assured Senator Walsh that it was not the intention of the bill to force arbitration on unwilling parties and he "would not favor any kind of legislation that would permit the forcing a man to sign that kind of a contract." *Hearings on S.B.*

4213 and S.B. 4214 before the Subcommittee of the Senate Committee on the Judiciary, 67th Cong., 4th Sess. (1923) at 10.

Similarly, during the Congressional hearings in 1924, Julius Cohen was asked to respond to the contention that arbitration clauses are used by railroads in "take it or leave it" contracts with shippers. He responded that there are statutory safeguards to protect individuals against the harsh effects of contracts of adhesion, stating, by way of illustration, "you can not get a provision into an insurance contract to-day (sic) unless it is approved by the insurance department." 1924 Hearings at 15. Mr. Cohen's comment is consistent with the simple proposition advanced by Massachusetts in *Connolly*: by enacting the FAA, Congress did not intend to deny the states their regulatory prerogative to prevent coerced arbitration through regulation of the process of contract formation. Moreover, Mr. Cohen's written comments provided to Congress reinforce the notion that the states could protect their citizens from unwanted arbitration in adhesive contracts without offending the FAA:

There is no disruption therefore by means of the Federal bludgeon to force an individual State into an unwilling submission to arbitration enforcement. The statute cannot have that effect.

1924 Hearings at 40. *Connolly*, however, interprets the FAA in such a way as to have precisely "that effect" by restricting the states' authority to require that arbitration be consensual.

IV. CONNOLLY MISCONSTRUES PRECEDENT OF THIS COURT IN RULING THAT THE FAA PROHIBITS REASONABLE STATE REGULATION OF ARBITRATION

The result in *Connolly* was influenced by rulings of this Court reflecting an expansive reading of the FAA. In none of those cases, however, was there any doubt that the parties had fairly contracted to arbitrate their disputes. Instead, the Court was merely asked to, and consistently did, rule that agreements to arbitrate are enforceable and that states are preempted by the FAA from denying enforcement of valid agreements to arbitrate.²

² See *Rodriguez De Quijas v. Shearson/American Express, Inc.*, 109 S.Ct. 1917 (1989) (customer agreement with brokerage house contained a clause to arbitrate controversies relating to investment accounts); *Perry v. Thomas*, 482 U.S. 483 (1987) (state law cannot invalidate an employment contract requiring arbitration of dispute with employer); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (customer agreement with brokerage house contained a clause to arbitrate controversies relating to investment accounts); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985) (distributor contract for the sale of automobiles had a provision that all disputes would be settled by arbitration); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985) (customer agreement with brokerage house contained a clause to arbitrate any controversy between the parties relating to the agreement); *Southland Corp. v. Keating*, *supra* (states may not require judicial forum for resolution of contract disputes where parties have contracted for arbitration); *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1 (1983) (construction contract contained a clause to arbitrate all claims and disputes relating to the agreement); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974)

(Continued on following page)

That there are limitations upon FAA preemption of state laws affecting arbitration was recognized by this Court in *Volt*. In *Volt*, the Court upheld a California procedural rule permitting a stay of arbitration pending resolution of related litigation involving third parties who were not bound by the arbitration agreement.

Volt's expression of the purpose of the FAA demonstrates the error of the court in *Connolly*. The majority noted that there is no federal policy favoring mandated arbitration:

The FAA contains no express pre-emption provision, nor does it reflect a congressional intent to occupy the entire field on arbitration.

* * *

It simply requires courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms.

* * *

Arbitration under the Act is a matter of consent, not coercion, and parties are generally free to

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(contract for the sale of an international business had a clause providing that any controversy arising out of the agreement would be referred to arbitration); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117 (1973) (New York Stock Exchange form agreement between employer and employee contained a provision whereby the parties agreed to arbitrate controversies arising out of termination of employment); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967) (consulting agreement had a clause by which the parties agreed that any controversy arising out of the contract would be settled by arbitration).

structure their arbitration agreements as they see fit.

109 S.Ct. 1254-5. The Massachusetts regulations do not undermine these principles; indeed, by insuring that an arbitration agreement is truly "privately negotiated," those regulations promote the policies underlying the FAA.

The effect of *Connolly* is to make arbitration a sacred cow which cannot be subject to reasonable regulation by the states for consumer protection. This position is simply not justified by the FAA or Supreme Court precedent. *Volt* removes any doubt that there is room for state regulation of arbitration. The appropriate inquiry for purposes of preemption analysis is whether state regulation of arbitration "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

The effectiveness of contractual arbitration as a means of dispute resolution is premised upon the assumption that the parties knowingly and voluntarily have chosen to be bound by the arbitral process. The *Connolly* decision is fatally flawed because it ignores this principle in adopting a *per se* rule invalidating any state regulation affecting arbitration, regardless of the nature of the state's interest in regulating a particular industry.

V. THE STATES HAVE A LEGITIMATE INTEREST IN REQUIRING THAT ARBITRABILITY BE NEGOTIABLE

The rule of *Connolly* establishes precedent which threatens to invalidate a large spectrum of state

regulation. While *Connolly* involves only the securities industry in Massachusetts, under the law of the case any state regulation which singles out arbitration for special treatment is vulnerable to an FAA preemption challenge.

Although this Court has determined that the states may not eliminate arbitration as an option for dispute resolution, it has recognized that Congress has determined that arbitration may not be appropriate for the resolution of some disputes arising under federal law.³ This recognition of the differences between judicial and

³ This Court on several occasions has determined that the "proper relationship between federal courts" and alternative dispute resolution favors granting litigants access to the former. *Alexander v. Gardner-Denver Co.*, 415 U.S. 36, 38 (1974) (emphasis added). In *Alexander*, the Court found that "the fact-finding process in arbitration usually is not equivalent to judicial fact-finding. . . . [A]nd the rights and procedures common to civil trials . . . are often severely limited or unavailable." *Id.* at 57-58. The Court concluded that "the federal policy favoring arbitration of labor disputes and the federal policy against discriminatory employment practices can best be accommodated" by allowing a Title VII plaintiff access to federal courts regardless of whether the dispute was first litigated in arbitration. *Id.* at 59 (emphasis added). See also *McDonald v. West Branch*, 466 U.S. 284 (1984) (wherein the Court ruled that federal courts should not give any effect to arbitration resolutions of 42 U.S.C. § 1983 actions); *Barrentine v. Arkansas-Best Freight System, Inc.*, 450 U.S. 728, 744 (1981) (wherein the Court, over the dissent of Chief Justice Burger in which he extolled the virtues of arbitration, noted again that "arbitral procedures [are] less protective of individual statutory rights than are judicial procedures" and held that employees have a right to bring minimum wage claims under the Fair Labor Standards Act in court).

non-judicial procedures cannot be ignored by the states any more than it can be ignored by the federal government. Subject only to the limitation that state regulation cannot frustrate the objectives of the FAA, the states must be free to consider the differences between arbitration and judicial procedures in regulating the process of contract formation.

That it may be appropriate for the states to subject arbitration to special conditions through laws governing contract formation was recognized by the Fourth Circuit Court of Appeals in *Supak*. The court ruled that it is permissible under the FAA for a state to define the addition of arbitrability to a commercial contract as a material alteration requiring written consent by both parties. Under *Connolly*, the state rule would not have survived, because it "singles out" arbitration for special treatment not applicable to other contractual provisions.

The implications of the First Circuit ruling are staggering. While arbitration has gained recognition as an acceptable alternative to judicial procedures, the states have an interest in reducing the risk that their citizens would unknowingly or unwillingly forfeit an option of judicial relief or administrative remedies provided by state law. This interest is particularly important in industries where market forces do not provide opportunities for informed waivers by consumers.

The states' general acceptance of arbitration as an efficient and inexpensive means of resolving contractual disputes has been accompanied in many instances by regulations designed to protect the consumer from an uninformed or coerced waiver of rights to access to a

judicial forum. For example, arbitration of medical claims, while gaining widespread acceptance, is subject to certain disclosure requirements in many states.⁴ Similar concerns have prompted some states to regulate arbitration imposed through adhesive contracts in motor vehicle franchise agreements.⁵ Privately negotiated arbitration is desirable only if it is mutually acceptable to all parties who would be bound by it. Otherwise, it has the potential of becoming a tool by which those who dominate an industry may exert their economic strength to avoid rather than embrace a fair and impartial resolution of contractual disputes.

CONCLUSION

The *Connolly* decision presents a legal issue which has not yet been addressed by this Court and which is the subject of disagreement among the circuits. If left undisturbed, the ruling threatens to undermine seriously the legitimate interests of the states in assuring that contractual arbitration is truly a matter of consent, not coercion.

⁴ See examples given in Massachusetts' petition for certiorari at 28-30.

⁵ See *Saturn Distribution Corp. v. Williams* (n. 1).

Accordingly, amici urge that the Court grant a writ of certiorari to decide this significant question.

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IN THE
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MICHAEL J. CONNOLLY,
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Petitioners,

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Respondents.

*Petition for Writ of Certiorari to
the United States Court of Appeals
for the First Circuit*

**BRIEF FOR NORTH AMERICAN
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ASSOCIATION, INC.,
AS AMICUS CURIAE**

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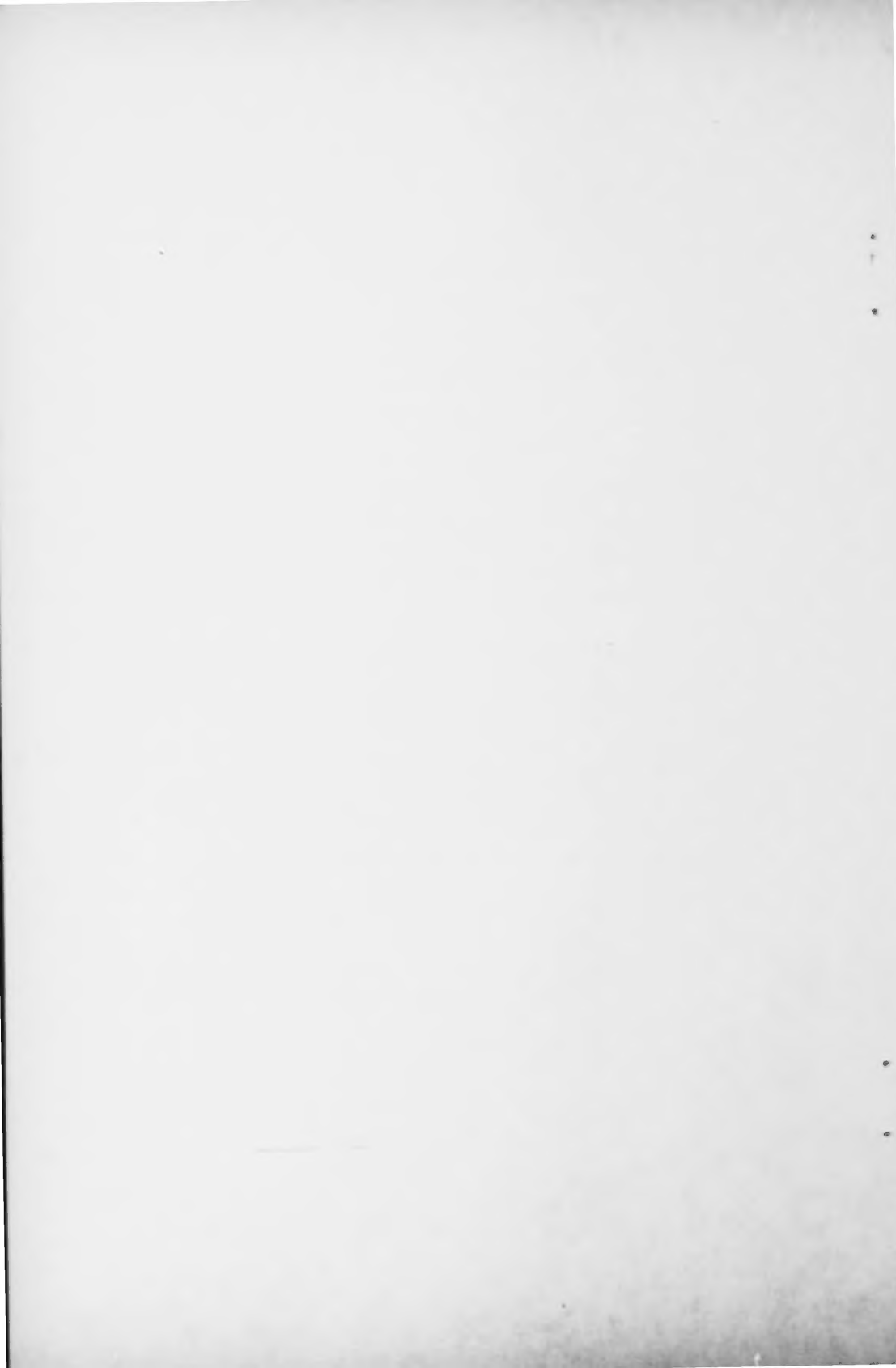
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No. 89-894

In The
SUPREME COURT OF THE UNITED STATES
October Term, 1989

MICHAEL J. CONNOLLY,
Massachusetts Secretary of State,
and
BARRY C. GUTHARY, Director,
Massachusetts Securities Division,
Petitioners,

v.

SECURITIES INDUSTRY ASSOCIATION, et al.,
Respondents.

Petition for Writ of Certiorari to
the United States Court of Appeals
for the First Circuit

BRIEF FOR NORTH AMERICAN
SECURITIES ADMINISTRATORS
ASSOCIATION, INC.,
AS AMICUS CURIAE

AUTHORITY TO FILE AND POSITION
OF AMICUS CURIAE

This brief is filed pursuant to Rule
36.1 of the Court's Rules by written
permission of the parties to the case.
Such written permission is filed herewith.
The brief supports the position of the
petitioners.

STATEMENT OF THE INTEREST
OF THE AMICUS CURIAE

The North American Securities Administrators Association, Inc. ("NASAA") is an association of state and provincial securities administrators in the United States, including the District of Columbia and Puerto Rico, Canada and Mexico, which, since 1918, has worked for investor protection. State securities commissioners are charged with regulating the securities markets and combatting securities frauds in their respective jurisdictions.

The dual system of federal and state regulation of securities is recognized by Section 18 of the Securities Act of 1933, 15 U.S.C. § 77r, and Section 28 of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb, which reserve jurisdiction of state securities commissioners over any security or person. Through this dual



system, the coordinated enforcement efforts of NASAA and the Securities and Exchange Commission ("SEC") have resulted in a most effective system for the enforcement of the securities laws. The SEC concentrates in large scale enforcement actions on international or multi-state levels, with the state commissioners either serving in a back-up or assisting role in such large scale actions or concentration on more local or regional enforcement actions.

The interest of NASAA in the present case is three fold. First, the Massachusetts Division of Securities, a NASAA member, has asked NASAA to participate in the present proceedings and to file an amicus curiae brief because of the impact that the decisions below will have upon the regulations he adopted and the Act that he administers. NASAA has already participated in the proceedings



before the Securities Division by having its General Counsel, Lee Polson testify. See Record Before the Secretary at 30-50; 104-176. It also filed an amicus curiae brief with the First Circuit.

Second, many other NASAA member agencies or states would like to consider adopting statutes or rules similar to the one adopted by the Massachusetts Division in the present case. In September 1988, NASAA released a report which indicated that fifteen of its member agencies were considering rules similar to that adopted by the Massachusetts Division. Among these states were: Florida, Georgia, Idaho, Iowa, North Dakota, Ohio, Pennsylvania, South Dakota, Washington, and Wisconsin. 20 Sec. Reg. & L. Rep. (BNA) 1436 (Sept. 23, 1988). In addition bills have been introduced in the legislatures of five states, California, Louisiana, Maryland, Oregon, and

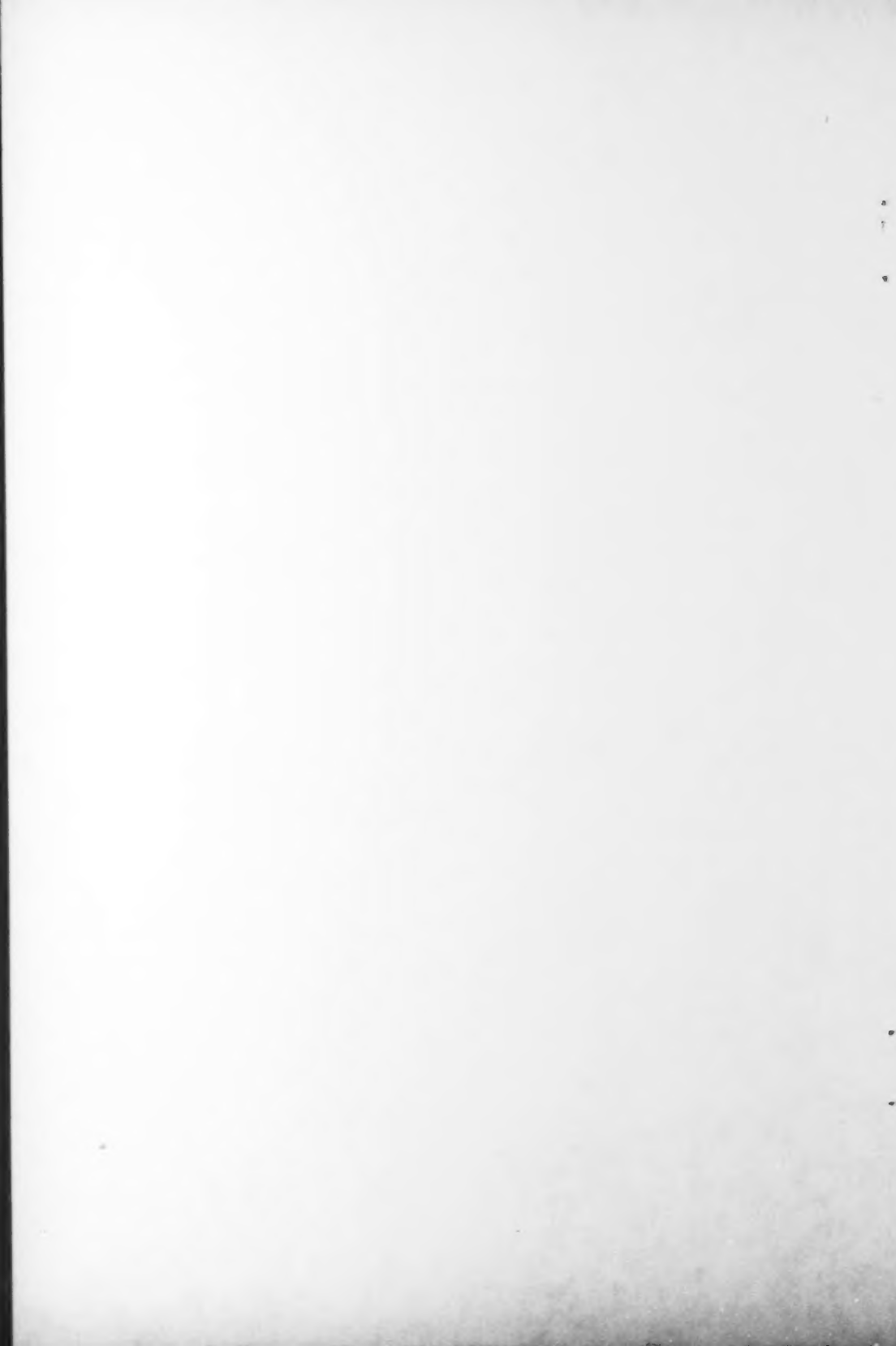


Washington, to bar broker-dealers from requiring mandatory arbitration clauses in their brokerage contracts as a condition for opening an account. See Cal. SB No. 1889, discussed in 20 Sec. Reg. & L. Rep. (BNA) 381 (Mar. 11, 1988); La. SB No. 74, discussed in 21 Sec. Reg. & L. Rep. (BNA) 745 (May 19, 1989); Md. SB No. 72, discussed in 21 Sec. Reg. & L. Rep. (BNA) 82 (Jan 13, 1989); Ore. SB No. 925, discussed in 21 Sec. Reg. & L. Rep. (BNA) 1805 (Dec. 8, 1989); Wash. SB No. 5787, discussed in 21 Sec. Reg. & L. Rep (BNA) 980 (July 7, 1989).

Since the decision by the First Circuit in the present case, an informal survey of its member agencies by NASAA shows that three members, Delaware, North Carolina, and Iowa, have plans to consider rules similar to the Massachusetts rule in 1990. In addition, the Oregon legislature has established an interim legislative

committee to consider mandatory arbitration clauses with a view toward introducing bar legislation in the 1991 session. 21 Sec. Reg. & L. Rep. (BNA) 1805 (Dec. 8, 1989).

Finally, NASAA, as an organization, is extremely interested in ensuring that the investors are treated in a fair and unbiased manner in the arbitration process. This concern has lead NASAA to call continually for federal and state regulation to ensure the voluntariness of arbitration agreements. In September 1987, immediately following this Court's decision in Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), NASAA formed an Ad Hoc Committee to study arbitration and to make recommendations how the process could be improved to provide greater investor protection. In December 1987, NASAA urged Congress to require brokers to negotiate arbitration



agreements and to provide potential customers with a separate disclosure document which would explain the terms and implications of mandatory arbitration clauses. Statement of James C. Meyer Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce (Dec. 16, 1987). NASAA's concern were noted in the comments of Subcommittee Chairman Markey and member Boucher and several witnesses at a hearing before this same subcommittee on March 31, 1988. 20 Sec. Reg. & L. Rep. (BNA) 492 (Apr. 1, 1988). On June 1, 1988, NASAA's Ad Hoc Committee published its recommendations for a "top-to-bottom overhaul" of the securities arbitration procedures including a prohibition on broker-dealers denying services to customer who refuse to sign predispute arbitration agreements. 20 Sec. Reg. & L. Rep. 850 (June 3, 1988). A week later,

NASAA's president James Meyer, Director of the Tennessee Division of Securities, appeared before the House Energy Subcommittee and again urged Congress to prohibit broker-dealers from demanding the signing of predispute arbitration agreements as a condition for opening a brokerage account. 20 Sec. Reg. & L. Rep. (BNA) 870 (June 10, 1988). This testimony lead, in part, to the introduction by Representative Boucher of HR 4960, 100th Cong. 2d Sess., on June 30, 1988, which included a provision barring arbitration clauses as a precondition for opening a securities account. 20 Sec. Reg. & L. Rep. (BNA) 1054 (July 8, 1988).

REASONS FOR GRANTING THE WRIT

A year ago this case would have come to the Court by appeal as a matter of right under former 28 U.S.C. §1254(2). Cf. City of New Orleans v. Dukes, 427 U.S. 297 (1976). Today the case comes before the



Court under the discretionary writ of certiorari. As will be seen below, the outcome should not change. The Court should grant full review because the case meets the Court's traditional test for the granting of certiorari formulated by Chief Justice Taft that it "involve[s] principles, the application of which are of wide public importance or governmental interest, and which should be authoritatively declared by the final court." Stern, Gressman, and Shapiro, Epitaph for Mandatory Jurisdiction, 74 ABA J. 66, 68 (Dec. 1988). The case also meets other often-cited tests for the granting of certiorari in that there is a potential conflict between the Circuits and that the lower courts made a major mistake in the interpretation of the relevant federal statute which will have wide impact. Each of these points will be examined below.



I. THE DECISION BELOW PRESENTS AN IMPORTANT QUESTION CONCERNING THE PREEMPTION OF THE STATE'S AUTHORITY TO PROTECT INVESTORS IN THE FORMATION OF ARBITRATION AGREEMENTS.

The case involves a Rule adopted by the Massachusetts Securities Division under the Massachusetts Uniform Securities Act. The Rule declared, among other things, that it was an unethical business practice for a broker-dealer to demand that a customer sign a predispute mandatory arbitration clause as a condition for the opening of a brokerage account. The Rule also required the broker-dealer to disclose the legal effect of such predispute arbitration agreements. The Rule did not prohibit predispute arbitration clauses. Instead it required two things: (1) that such clauses be the product of negotiation between the parties, and voluntarily accepted by the brokerage customer, rather than being a



contract of adhesion imposed upon the customer by the broker as a condition of doing business; and, (2) that the customer be given information about the effect of such agreement so that he could make an intelligent choice as to whether he wished to accept it. Such Rule is clearly within the police power of the Commonwealth. Hall v. Geiger-Jones, 242 U.S. 539 (1917). The First Circuit, however, held that the Rule was implied pre-empted because it conflicted with the Congressional policy behind the Federal Arbitration Act, 9 U.S.C. §1 et seq.

Because of the delicate balance between the dual sovereigns within our Federal system, this Court, on a number of occasions, has indicated that federal preemption should be cautiously approached when a federal-state balancing of respective governmental powers between the two sovereignties is involved. Jones

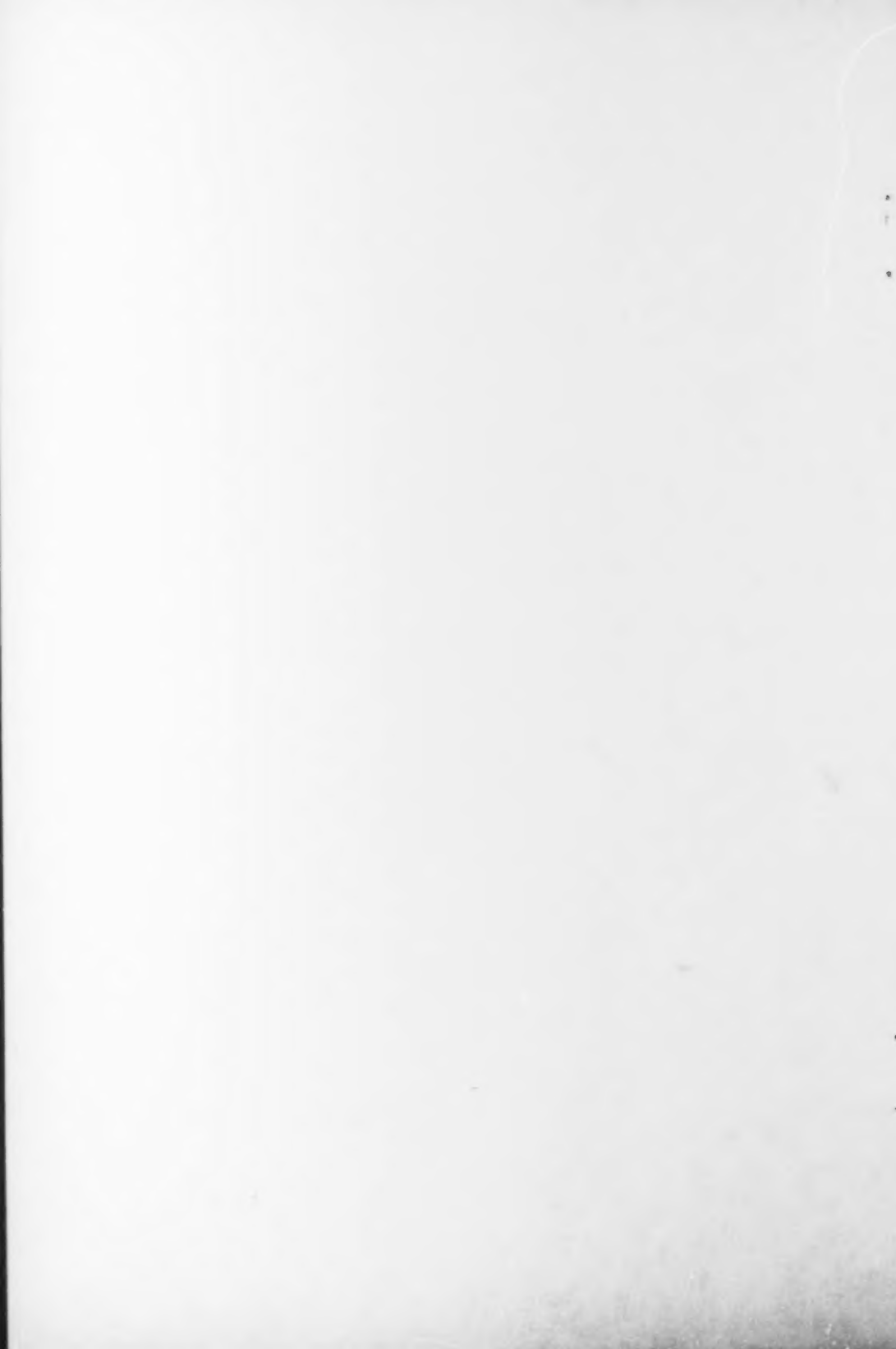


v. Rath Packing Co., 430 U.S. 519 (1977); United States v. Bass, 404 U.S. 336 (1971); Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132 (1963); Rice v. Santa Fe Elevator Corp., 331 U.S. 218 (1947). Thus preemption "is not to be lightly presumed". California Federal Savings & Loan Ass'n v. Guerra, 479 U.S. 272, 281 (1987); Maryland v. Louisiana, 451 U.S. 725, 746 (1981). This is particularly true where the claim to preemption is implied rather than express, Aloha Airlines v. Director of Taxation, 464 U.S. 7 (1983), and where the field claimed to be preempted is one within the traditional police power of the state. Hillsborough County v. Automated Medical Inc., 471 U.S. 707, 715 (1985); Jones v. Rath Packing Co., supra. As a result this Court has stated: "We start with the assumption that the historic police powers of the State were not to be superseded by



the Federal Act unless that was the clear and manifest purpose of Congress." Rice v. Santa Fe Elevator, supra, at 230.

Because of the delicate balance between federal government as the superior sovereign and Commonwealth of Massachusetts as the inferior sovereign in the present case, the extreme caution which this Court has indicated should be exercised when implied rather than express preemption is involved, and the presumption against such preemption in areas traditional within the police power of the states, the Commonwealth of Massachusetts has a right to expect that the final decision on preemption of the Rule adopted by its Securities Division will be made by this Court rather than some inferior federal court. In the words of Chief Justice Taft, this is a case which "involves principles, the application of which are of wide

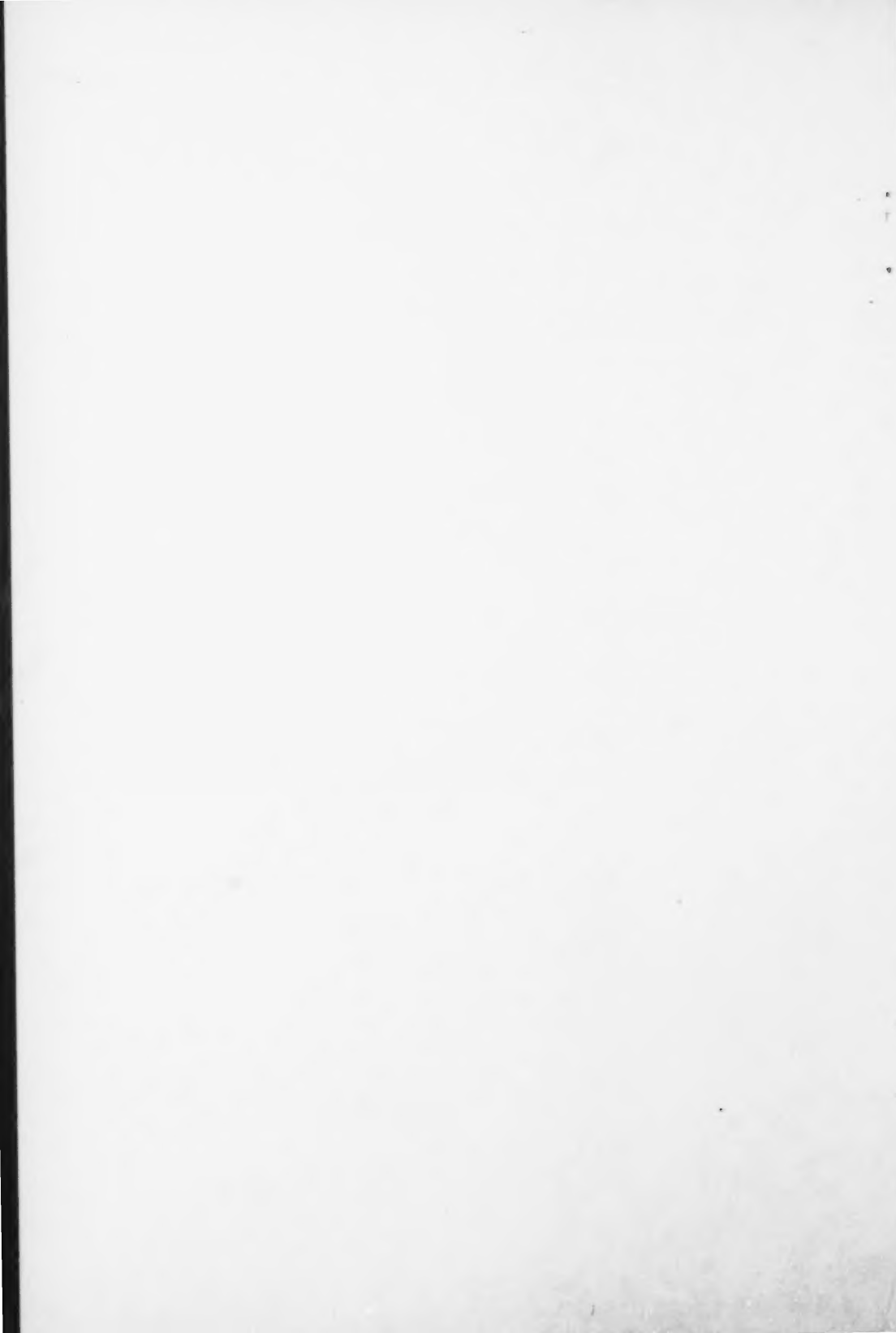


...governmental interest, and which should be authoritatively declared by the final court." While the right of the Commonwealth to demand such hearing ended with the repeal of Section 1254(2), this Court should exercise its discretion, grant review by certiorari, and definitively determine whether the Massachusetts Rule is implied preempted by the Federal Arbitration Act.

II. THE COURT SHOULD GRANT CERTIORARI BECAUSE THE CASE HAS NATIONAL INTEREST TO ALL SECURITIES REGULATORS.

The second part of Chief Justice Taft's test for the granting of certiorari is that the case has national significance and be one which should be authoritatively settled by the final court. Again the present case meets these criteria.

NASAA and its member state agencies have been increasingly concerned that mandatory predispute arbitration clauses



are becoming contracts of adhesion. As such, the individual investor has little or no choice as to whether he wishes to accept such an agreement. If he wishes to participate in the public securities market utilizing the services of a broker-dealer, he must agree to such a provision. As will be seen below, this is clearly contrary to the intent of Congress in adopting the Federal Arbitration Act.

Congress intended to make sure that a contract to arbitrate voluntarily agreed to by the parties would be enforced according to their agreement. Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University, __U.S.__, 109 S.Ct. 1248 (1989). It clearly did not intend to force persons to arbitrate when there was no voluntary agreement to do so. A contract of adhesion requiring a mandatory predispute agreement to arbitrate where



the individual investor has no choice, but to accept or refrain from participating in the market, is not a voluntary agreement. This is especially true when viewed in light of the fact that the regulations of the New York and American Stock Exchanges and the National Association of Securities Dealers require all their members to arbitrate claims with their customers, if the customer so requests.

The industry's own statistics bear out that the mandatory arbitration clause is rapidly becoming a contract of adhesion. The industry figures reported to the Securities and Exchange Commission indicate that a year after this Court's decision in Shearson/American Express, Inc. v. McMahon, supra, in June 1988, that members of the brokerage community required a mandatory arbitration clause in 90 percent of their margin accounts and in 95 percent of their option accounts. 20



Sec. Reg. & L. Rep. (BNA) 833 (June 3, 1988). This percentage will become even greater as a result of the adoption by the Securities Industry Association of its new Model Customer Agreement form on July 17, 1989. This form contains a mandatory arbitration agreement for all margin customers. SIA has recommended that all its member firms adopt the Model Agreement form. 21 Sec. Reg. & L. Rep. (BNA) 1103 (July 8, 1989).

Industry spokesmen point out, however, that such mandatory agreements are required in less than 50 percent of the industry's cash accounts. This figure, while accurate at the time it was made, is now misleading for several reasons. First, many of the people who have cash accounts also have margin or option agreements, whether or not they actually trade on margin or in options. Typically, such margin or option agreements require the

arbitration of all disputes with the broker whether they arise out of a margin or option transaction or not. As a result, a very large number of cash account disputes are covered. It is only the cash customer who does not execute a margin or option agreement who will avoid the broker's mandatory agreement.

Second, both the industry spokesmen and the SEC Staff admit that the practice of requiring mandatory arbitration clauses in cash accounts is increasing. Three months after the McMahon decision, in September 1987, industry official predicted that companies will be encouraged by their own legal advisers to have cash customers sign predispute arbitration agreements. 19 Sec. Reg. & L. Rep. (BNA) 1388 (Sept. 18, 1987). This trend was confirmed by the SEC Staff in June 1988 when the Director of Market Regulation reported that there was a growing broad based trend toward



requiring predispute arbitration agreements in cash accounts. 20 Sec. Reg. & L. Rep. (BNA) 833 (June 3, 1988).

Recognizing this growing trend, NASAA and its member state agencies have attempted to secure federal and state statutes or regulations which will ensure voluntariness in the arbitration agreement process. In December 1987, NASAA recommended that Congress require broker-dealers to negotiate arbitration agreements. Statement of James C. Meyer Before the Subcomm. on Telecommunications and Finance of House Comm. on Energy and Commerce (Dec. 16, 1987). This call was renewed in June 1988. 20 Sec. Reg. & L. Rep. (BNA) 850 (June 3, 1988). In September 1988, at the time, the Massachusetts Securities Division adopted the Rule challenged in the present case, NASAA reported that some 15 of its other members were considering the adoption of

similar regulations. 20 Sec. Reg. & L. Rep. (BNA) 1436 (Sept. 23, 1988).

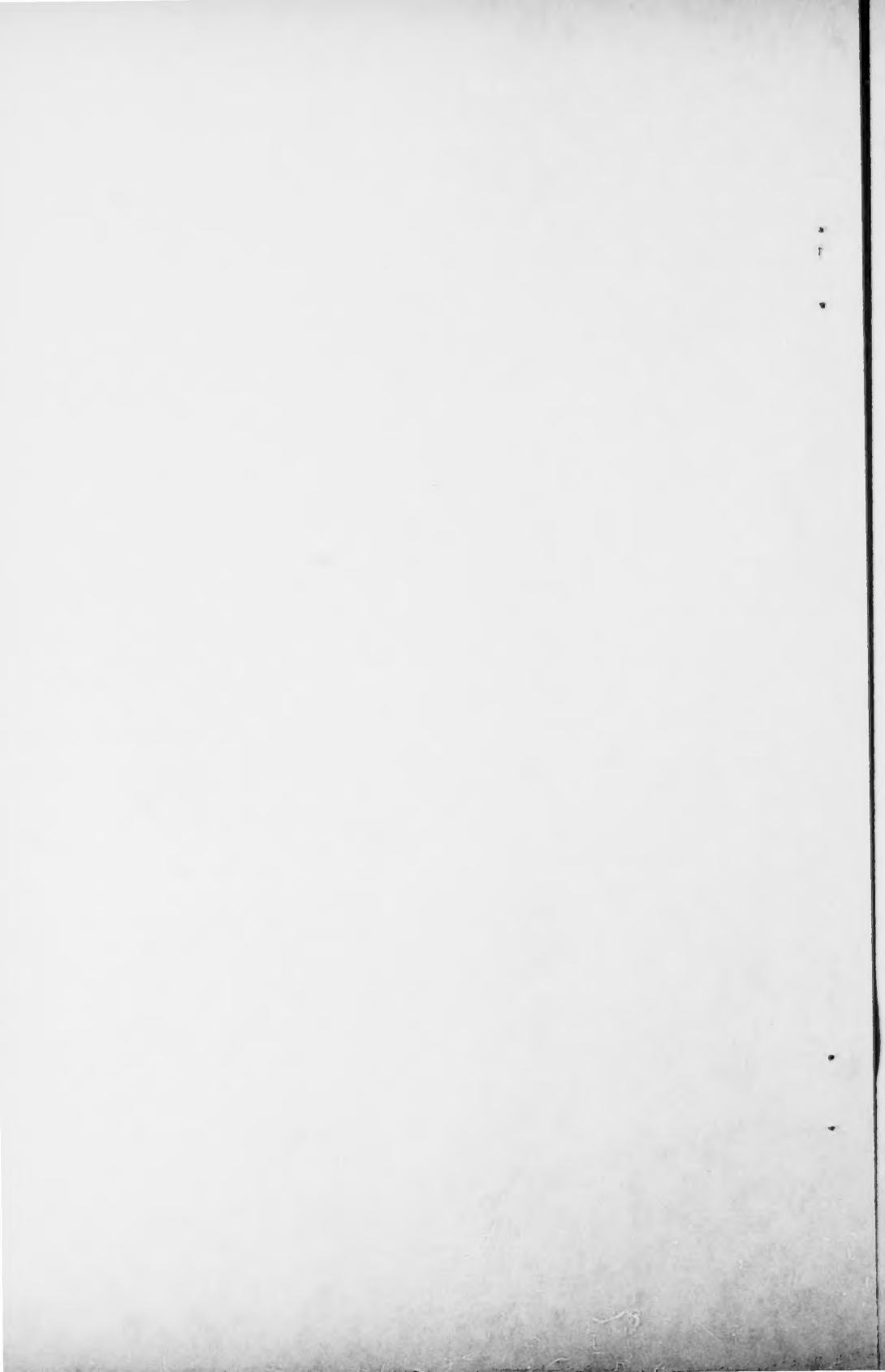
Nor is NASAA the only group concerned about the proliferation of the mandatory arbitration agreements in brokerage contracts through contracts of adhesion. As noted above at p.4, five state legislatures have considered bills which would prohibit brokerage contracts of adhesion requiring mandatory arbitration. As early as 1979, the SEC also became concerned about these contracts. In SEC Exchange Act Rel. No. 15984 (July 2, 1979), 17 SEC Docket 1167, the Commission recognized that arbitration clauses were "routinely required for margin accounts and often for cash accounts" The Commission went on to state: "Moreover, the customer may be precluded from doing business with the broker-dealer if he or she refuses to sign the agreement or the



broker-dealer is unwilling to accept any modifications of its terms." Id. at 1169.

More recently a study conducted by the SEC Staff lead the staff to recommend that the SEC initiate legislation to curb the use of these contracts of adhesion. See [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,241 (June 8, 1988). The Commission, however, refused to initiate such legislation or support HR 4960, 100th Cong. 2d Sess. (June 30, 1988), introduced by Representative Boucher, which would also outlaw such agreements. 20 Sec. Reg. & L. Rep. (BNA) 1054 (July 8, 1988).

The academic community is also concerned about the spread of these non-negotiable contracts of adhesion requiring arbitration in brokerage contracts. McCauliff and Tyms in their article New Protections in Arbitrating Public Securities Disputes in the Wake of McMahon: Foregone Conclusion or Will-O'-



The Wisp?, 34 VILL. L. Rev. 25, 56 (1989)

said:

[Public confidence in the arbitration process] can only be earned by maintaining a de facto as well as a de jure image of fairness." The de facto image of fairness can be promoted by removing any appearance of adhesion contracts. A contract of adhesion arises when a party with superior bargaining power presents a standardized form contract to a party of lesser bargaining power whose choice is limited to accepting or rejecting the contract without opportunity to negotiate. While it is true that mere inequality in bargaining power does not make a contract unenforceable, nonetheless, when the arbitration agreement is presented as a precondition to opening an account, the image of de facto fairness is seriously compromised. Therefore, it should be clear to the investor that the agreement is entirely optional.

[Footnotes omitted.] See also DiFiore, Problems in Alternative Dispute Resolution: Arbitration Agreements as Contracts of Adhesion in Consumer Securities Disputes, 90 Commercial L.J. 259 (1988); Katsoris, The Arbitration of A



Public Securities Dispute, 53 Fordham L. Rev. 279 (1984).

Nor is the concern of NASAA limited to mandatory arbitration contracts in the brokerage area. NASAA members are increasingly seeing private placement memoranda for offering sold under the securities registration exemptive provisions of both the state and federal securities acts which contain mandatory predispute arbitration agreements. Again, these offering are being made on a take-it-or-leave-it basis with the purchaser having no opportunity to reject the arbitration clause. Unlike brokerage agreements which this Court in McMahon held could be supervised by The SEC under Section 19 of the Exchange Act of 1934, 15 U.S.C. §78s, these mandatory arbitration agreements are not subject to direct SEC control or do not have to call for arbitration in a system subject to SEC

control. Thus the investor, if he wishes to invest in these products, has no choice but to agree to arbitrate, possibly in a forum which is not subject to regulation by the SEC. If the present case is allowed to stand, the states will be powerless to protect investors from such overreaching. Southland Corp. v. Keating, 465 U.S. 1 (1984).

Thus, there is wide support for the curbing of contracts of adhesion which require mandatory arbitration in the securities area. However, the ability to implement these reforms at the state level is left in question by the First Circuit's decision in the present case. While the decision is not binding outside that Circuit, and some agencies and legislatures appear willing to push ahead with Rule or statutes similar to the Massachusetts Rule declared preempted, it would be better if the issue was finally



resolved by this Court. Therefore, NASAA urges this Court, on the basis of the public interest in this issue as outlined above, to grant certiorari and finally resolve the dispute.

III. THE COURT SHOULD GRANT
CERTIORARI BECAUSE THE
PRESENT CASE HAS WIDE
INTEREST BEYOND THE
SECURITIES AREA.

Following Chief Justice Taft's criteria, the Court should grant certiorari in the present case because it has wide interest beyond the securities field. Non-negotiable contracts of adhesion requiring predispute consent to arbitrate are proliferating in many areas other than securities. The Commonwealth identified a number of these areas in Point II of their brief. NASAA's research has identified a number of others.



The Commonwealth pointed out that the Bank of America and Marathon National Bank of Los Angeles are extensively using non-negotiable arbitration clauses in a wide variety of situations. The text of the Bank of America General Arbitration Clause and the one used in its Safety Deposit Agreements are reprinted in the Appendix to Comment, Lender Liability and Arbitration: Preserving the Fabric of Relationship, 42 Vand. L. Rev. 947,981 (1989). This article indicates that the Bank of California is also extensively using such clauses and reports the text of that Bank's clause. Id. at 982-983. The article also points out the advantages to banks of the wide-spread use of such clauses as an aid in the control of lender liability in commercial lender situations. Use of such clauses in lender situations as a means to control "excessive lender liability judgments" was

advocated by James Pitts in Pitts, Arbitrating Lender Liability Claims, 106 Bank. L.J. 227 (1989).

Such non-negotiable clause are appearing more frequently in the insurance areas. The Commonwealth pointed out their use in the malpractice and health care area. NASAA's research shows that such clauses are also being used in insurance re-insurance contracts, see Spotlight Report, Business Insurance 72, 74 (Nov. 6, 1989) (avail. on Nexis), and by State Farm, one of the largest retail insurance companies, in connection with its uninsured motorists coverage. Chicago Tribune, Chicagoland Section, p.2 (Sept. 19, 1989)(avail. on Nexis).

Finally, the Commonwealth noted the use of these agreements in connection with disputes between the automobile manufacturer and their dealers. In contrast to the decision by the First

Circuit in the present case, the court in Saturn Distribution Corp. v. Williams, Commissioner of the Department of Motor Vehicles of Virginia, 717 F. Supp. 1147 (E.D. Va.1989), appeal pending Doc. No. 89-2773 (4th Cir.) (oral argument heard Dec. 6, 1989); upheld the authority of the Commissioner to restrict the use of such clauses. NASAA has discovered that these clauses are also being used in connection with disputes between the automobile dealers and their retail customers. Ex Parte Warren, 548 So.2d 157 (Ala. 1989), cert. filed, Doc. No. 89-567, 58 U.S.L.W. 3291 (Oct. 4, 1989).

The First Circuit decision in the present case was extremely broad. In essence, it held that the states could not adopt any statutes or regulation affecting the use of arbitration clauses unless such legislation or rules applied to contracts generally. Thus, the state could not

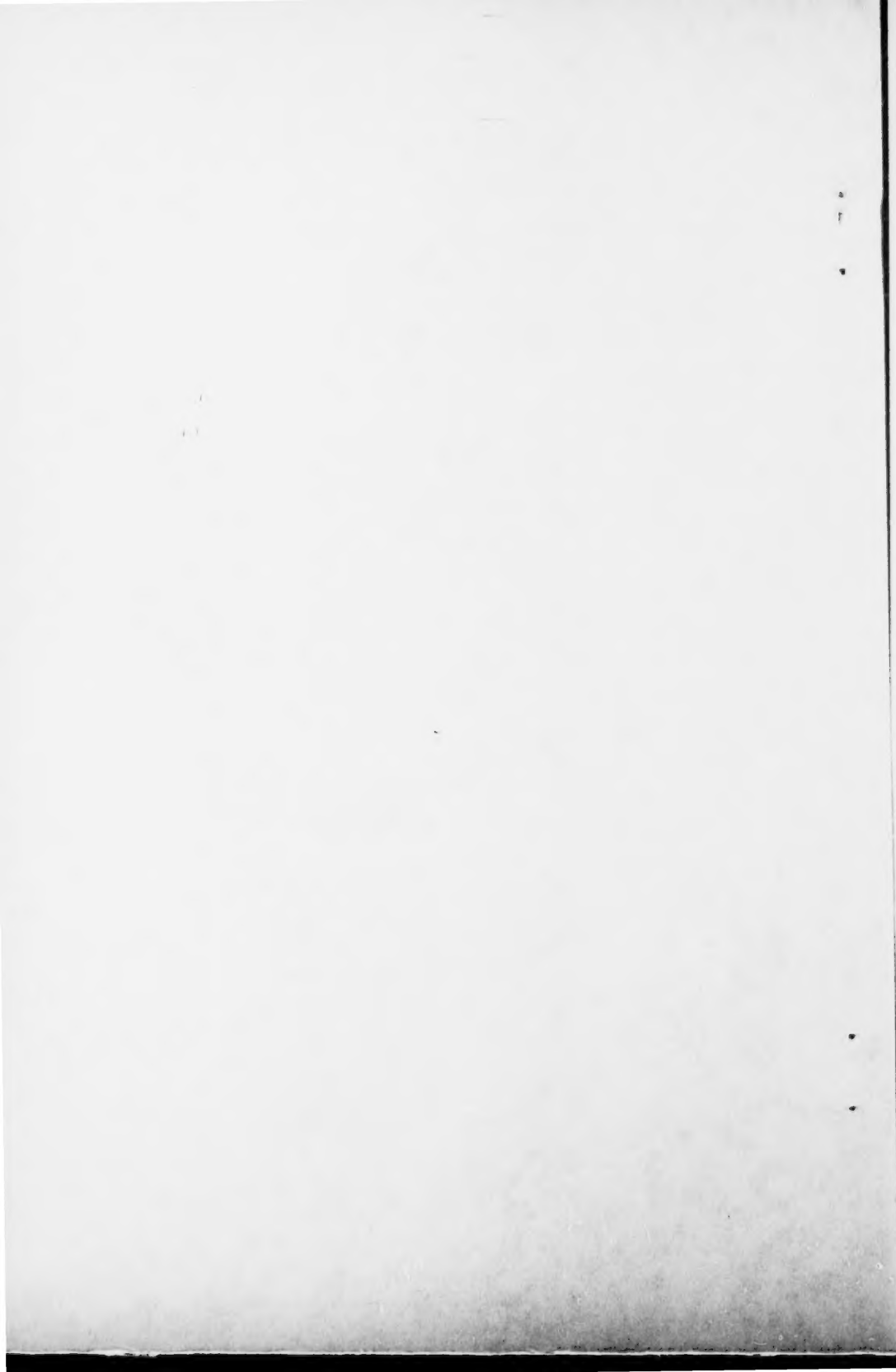
adopt limiting rules or legislation which was industry specific such as securities, banking, or insurance. If this decision is allowed to stand and followed by the other Courts of Appeal, it will have an extremely limiting effect on the ability of the states to protect their citizens from abusive arbitration practices in such traditional consumer protection areas as consumer credit, truth-in-lending, and automobile lemon laws. See Motor Vehicle Manufacturers Ass'n v. Abrams, 697 F. Supp. 726 (S.D.N.Y. 1988).

Concern about the extraordinary breadth of the First Circuit's decision in the present case and its application to areas beyond the securities area into other areas traditionally considered within the police powers of the states, NASAA understands has caused the Attorney General of Virginia to file a brief in support of the granting of certiorari in

the present case. It is NASAA's further understanding twenty-seven other state Attorney Generals joined in the filing of this brief. The fact of its filing and the support by the large number of other state attorneys general indicate the wide spread interest by the states and their regulatory agencies outside the securities area in the present case. NASAA joins with the state attorney generals in urging the Court to grant certiorari in the present case because of this wide spread interest it has generated in other areas of state regulation beyond securities.

**IV. THE COURT SHOULD GRANT
CERTIORARI IN THE PRESENT
CASE BECAUSE THERE IS A
POTENTIAL CONFLICT OF
INTEREST BETWEEN THE
CIRCUITS.**

Another traditional test used by the Court to determine whether to grant certiorari is whether there is a conflict



among the circuits on the issue presented. To date, NASAA is aware of only two cases which have considered the power of the states to regulate or control the use of non-negotiable contracts of adhesion requiring mandatory arbitration. They have reached opposite results. The First Circuit's decision in the present case held that the states could not adopt such statutes or regulations unless that applied to all contracts generally. The decision by the district court in Saturn Distribution corp. v. Williams, Commissioner of the Department of Motor Vehicles of Virginia, 717 F. Supp. 1147 (E.D.Va. 1989), appeal pending, was that such regulation was not preempted by the Federal Arbitration Act. Thus there is a potential conflict between the circuits on the issue which this Court should resolve.



V. THE COURT SHOULD GRANT CERTIORARI IN THE PRESENT CASE BECAUSE THE FIRST CIRCUIT MISCONSTRUED THE PURPOSES AND OBJECTIVES OF THE FAA.

Finally the Court should grant certiorari because the First Circuit misconstrued the purposes and objectives of the Federal Arbitration Act in two very important ways. First, the First Circuit ignored the clear legislative history that the FAA was intended to apply only to voluntary agreements to arbitrate and was specifically not intended to cover contracts of adhesion. Second, the First Circuit also failed to recognize that state law governs the contracting process by which an agreement to arbitrate is formed and that the states have traditionally had the power to refuse to enforce unconscionable contracts.

The legislative history of the FAA



makes clear that it is intended to apply only to voluntary agreements to arbitrate:

The record... shows only the great value of voluntary arbitrations but the practical justice in the enforced arbitration of disputes where written agreements for that purpose have been voluntarily and solemnly entered into.

S. Rep. No. 536, 68th Cong., 1st Sess. at 3. [Emphasis added.] This Court has on numerous occasions recognized this principle. Most recently the Court said in Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University, ___ U.S. ___, 109 S.Ct. 1248, 1256 (1989), that "Arbitration under the Act is a matter of consent, not coercion."

More specifically, during the hearings leading to the adoption of the Act, the question was raised by Senator Walsh as to the intent of the Act to cover arbitration in those situations where the agreement to arbitrate was a product of a

non-negotiable contract of adhesion.

Senator Walsh said:

The trouble about the matter is that a great many of these contracts that are entered into are not really voluntarily [sic] things at all. Take an insurance policy: there is blank in it. You can take that or you can leave it. The agent has no power at all to decide it. Either you can make that contract or you can not make any contract. It is the same with a good many contracts of employment. A man says: "These are our terms. All right, take it or leave it." Well, there is nothing for the man to do except sign it; and then he surrenders his right to have his case tried by the court, and has to have it tried before a tribunal in which he has no confidence at all.

Hearing on S. 4213 and S. 4214 before the Subcommittee of the Judiciary, 67th Cong., 4th Sess. at 9 (1923). Senator Walsh went on to ask similar questions concerning contracts of adhesion in the shipping and construction industries. Id. at 10-11. In all cases, the proponents of the bill indicated that they did not intend the bill to cover such contracts.

This legislative history was recognized and accepted by three members of this Court in Prima Paint Corp. v. Flood & Conklin Mfg., 388 U.S.395 (1967). Justice Black speaking for the three in dissent said:

Senator Walsh cited insurance, employment construction and shipping contracts as routinely containing arbitration clauses and being offered on a take-it-or-leave it basis to captive customers or employees. He noted that such contracts "are really not voluntary things at all." because "there is nothing for the man to do except to sign it; and then he surrenders his right to have his case tried by the court...." He was emphatically assured by the supports of the bill that it was not their intention to cover such cases.

Id. at 414. (Black, J. dissenting)

[Emphasis added.]

Second, it has long been held that state, not federal, law controls as to whether the parties have entered into a binding contract to arbitrate. EASSA Properties v. Shearson Lehman Bros., Inc.,



852 F.2d 1301, 1304 n.7 (11th Cir. 1988); Supak & Sons Mfg. Co. v. Pervel Indus. Inc., 593 F.2d 135, 137 (4th Cir. 1979); Cook Chocolate Co. v. Salomon, Inc., 684 F. Supp. 1177 (S.D.N.Y. 1988); Rush v. Oppenheimer, 681 F. Supp. 1045 (S.D.N.Y. 1988); Graniteville Co. v. Star Knits of Calif. Inc., 680 F. Supp. 587 (S.D.N.Y. 1988). Cf. Perry v. Thomas, 482 U.S. 483, 492 n.9 (1987). This conclusion is consistent with the opinion expressed by the proponents of the FAA as expressed in a 1925 article written immediately following the passage of the Act. They said:

It is no infringement upon the right of each State to decide for itself what contracts shall or shall not exist under its laws. To be sure whether or not a contract exists is a question of the substantive law of the jurisdiction wherein the contract was made.

Committee of Commerce, Trade & Commercial Law, The United States Arbitration Law and

Its Application, 11 ABA J. 153, 154 (1925).

NASAA submits that the same should be true under that portion of Section 2 of the Act which provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C §2. [Emphasis Added.] This Court in Shearson/American Express Co. v. McMahon, 482 U.S. 220, 226, 230 (1987), recognized that excessive economic power would provide a basis for voiding an arbitration agreement under ordinary principles of contract law under Section 2. See also, Katsoris, The Arbitration of A Public Securities Dispute, 53 Fordham L. Rev. 279, 307 (1984). Such contract would be unconscionable.

The determination of excessive economic power or unconscionability, however,

should be a matter of state, not federal, law. Further, a finding of such unconscionability can be made through legislative or administrative rule-making process as well as by court decision. The findings of the Secretary in adopting the Rule in the present case amounted to a finding of unconscionability. Such conclusion finds support in the academic literature, see e.g., DiFiore, Problems in Alternative Dispute Resolution: Arbitration Agreements as Contracts of Adhesion in Consumer Securities Disputes, 93 Commercial L.J. 259 (1988), and should have been respected by the First Circuit.

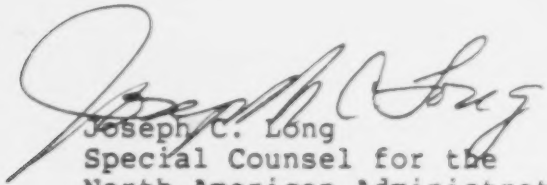
CONCLUSION

For the reasons set forth above and those outlined in the brief of the Commonwealth, NASAA joins with the Commonwealth in urging the Court to grant



the petition for writ of certiorari and
hear the case on its full merits.

Respectfully submitted,

A handwritten signature in cursive script, appearing to read "Joseph C. Long".

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